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ECONOMIC DEVELOPMENT IN MEXICO

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BEFORE THE

SUBCOMMITTEE ON
WESTERN HEMISPHERE AFFAIRS

AND THE

SUBCOMMITTEE ON INTERNATIONAL ECONOMIC
POLICY,
OCEANS, AND ENVIRONMENT

OF THE

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ECONOMIC DEVELOPMENT IN MEXICO

TUESDAY, JUNE 10, 1986

U.S. SENATE, SUBCOMMITTEE ON WESTERN HEMISPHERE AFFAIRS, AND SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY, OCEANS, AND ENVIRONMENT, OF THE COMMITTEE ON FOREIGN RELATIONS,

Washington, DC.

The subcommittees met, at 10:01 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Jesse Helms (chairman of the Subcommittee on Western Hemisphere Affairs) and Hon. Charles Mathias (chairman of the Subcommittee on International Economic Policy, Oceans, and Environment) jointly presiding.

Present: Senators Helms, Mathias, Murkowski, Evans, Zorinsky, and Dodd.

Senator HELMS. The subcommittees will come to order.

The Chair would apologize to our guests who are having to stand. We did not anticipate such a crowd. But I don't know that there is very much that we could have done about it anyhow, the room being the size that it is.

Today, the Subcommittee on Western Hemisphere Affairs begins the second in a series of public hearings on United States relations with Mexico. Since we intend to concentrate on economic issues today, we join in cosponsorship of this hearing with the Subcommittee on International Economic Policy under the chairmanship of the distinguished Senator from Maryland, Senator Mathias.

We welcome Senator Mathias here today.

The first public hearing in this series was held on May 13, about 1 month ago, or somewhat less than 1 month ago. As some of you may have noticed, it caught the attention of the news media.

For some reason, the news media both in the United States and in Mexico decided that this subcommittee was launching an attack on Mexico in an attempt to undermine the Government of Mexico and to make our relations with Mexico worse. It was charged that this subcommittee was somehow berating Mexico, that the chairman of this subcommittee was criticizing Mexico ignorantly, and that the problems in Mexico were primarily the result of problems in the United States.

It was even charged that the witnesses had been arbitrarily chosen to skew the testimony against Mexico.

Well, let the record show that this is all nonsense. The fact is this subcommittee invited every major agency of the United States Government having some relationship with Mexico. We invited these agencies to come before us and report on that relationship.

Thus, all of the key players were invited to testify, including the Attorney General of the United States.

What happened was that some of these witnesses came up here and committed the truth.

The truth, it turns out, was painful, and I fully admit that it was painful for both sides. But I also think it is necessary that I repeat verbatim what I said at the first hearing last month. I said then, and I say now, because Mexico is our next door neighbor, we have always felt that we have a special relationship. Unfortunately, the word "special" does not mean that the relationship is always good. What it means is that our long, mutual border binds us together for better or for worse. What affects one of us is bound to affect the other.

We want our relationship to be positive and mutually beneficial. Therefore, both countries have an obligation to understand what is happening in the other.

I am disappointed that both the Mexican Government and some in our own Government seem to feel that our countries do not have an obligation to understand what is happening in the other.

The situation in Mexico, I believe, is very grave. It is more grave today than it was 1 month ago. And if you will bear with me, let me quote one more paragraph from my statement of May 13. I stated then, and I quote: "We need to know these things because one way or another, the U.S. taxpayers will shortly be asked to prop up the Mexican economy. With the fall in oil prices, Mexico has no way even to keep up with the interest on its foreign debts. If the truth were known, I doubt that Mexico could meet its obligations even before the oil price fell. Mexico," I said then, "is in a spiral down."

Now that was 1 month ago. The spiral down is easily measured in terms of the peso-dollar exchange rate.

I have a chart which will be displayed [indicating] showing the exchange rate from 1952 to 1985.

In 1952, the rate was 12.5 Mexican pesos to the dollar. That rate continued fairly stable until 1976, when an influx of oil revenues led to inflation and the exchange rate went up to 19 to the dollar.

Many devaluations continued until 1981, when the exchange rate was over 26 pesos to the dollar. But, on February 18, 1982, the peso was floated, and by August, the central bank was running out of foreign exchange due to capital flight.

By August 19, 1982, it was 115 pesos to the dollar, and Mexico could not make its foreign debt payments.

It was then that the U.S. taxpayers were called in to bail out the Mexican economy to the tune of more than $9 million that was arranged in a weekend deal in August 1982, when everyone in Washington was out of town.

This involved the Treasury's exchange stabilization fund, PEMEX, and the U.S. Department of Energy, plus so-called bridge loans, and loans from other industrialized countries.

Now, the question is are we at that point again. The American people have a right to know.

There is a second chart which picks up where the first chart leaves off. I would ask that the second chart be placed so that it connects with the first one [indicating].

This chart shows the peso from this past January to this past Friday.

On May 13, when we held our first hearing, the peso-dollar exchange rate stood at 528 Mexican pesos to the dollar. By last Friday, it stood at 780 pesos to the dollar, or a fall of 48 percent since these hearings began.

The collapse began in earnest 1 week ago, on June 3, when it rose to 550; on June 4, it was 600; on June 5, it was 690; and on June 6, it was 780.

Now, then, this means that the average Mexican citizen has seen the value of his life savings reduced almost by one-half in the past 3 weeks.

Fortunately, however, yesterday the peso rallied to 730 with the announcement from Mexico that the Government did not intend to default on its loans.

The debt situation is portrayed in a third chart with data taken from the World Bank. I ask that that be held up [indicating].

In 1980, the Mexican foreign debt was $57 billion. When the crisis developed in 1981, it was $86 billion. It has gradually increased to the point that the World Bank projects a debt of $103 billion by the end of 1986.

I think it is fair to say that the world is waiting to see whether Mexico will take the steps to pay these debts.

Secretary Baker and Federal Reserve Chairman Volcker are in Mexico today. There is speculation, such as in the Wall Street Journal, for example, and other papers, whether Mexico will pay, and, if so, in dollars or in pesos; and, if in pesos, what that would mean in the light of fluctuating value of the peso.

These are some of the questions we expect our witnesses to touch on today. We wonder whether another bailout is in the offing, perhaps when Congress is again out of town for the Independence Day recess.

However, I must say this. If Congress is asked to participate in another such bailout at the expense of the American taxpayers, this Senator does not intend to be a party to such action.

Senator Mathias.

Senator **MATHIAS**. Thank you.

The Subcommittee on International Economic Policy is glad to be able to join with the Subcommittee on Western Hemisphere Affairs in receiving testimony on the present state of the economy in Mexico.

Mexico's economic difficulties, of course, have been very much in the news lately. In that connection, I will submit for the record the story in today's New York Times dealing with the Mexican debt situation and ask unanimous consent that it be included in the record.

Senator **HELMS**. Without objection.

Senator **MATHIAS**. And at an appropriate point.

[The information referred to appears in the appendix.]

Senator **MATHIAS**. It is, of course, not the first time in recent years that this has been the case.

I do not believe that there is any citizen of the United States who does not regret and sympathize with the hard times that are being faced by the people of Mexico.

I think we can sympathize with the people of Mexico all the more because, to a very large degree, their difficulties are not of their own making. High interest rates, worldwide high interest rates, which have pervaded the entire international economic system, really were the cause of precipitating Mexico's problems in the early years of the 1980's. Then, following the high interest rates and the brutal effect that that had on the Mexican economy, there was the fall in oil prices—again, a worldwide phenomenon, and not just a Mexican phenomenon. It was a worldwide phenomenon. The plummeting oil prices in the last year have made recovery from the previous difficulties, of course, all the more difficult.

Incidentally, Jesse, just so that we don't start any panics in Mexico, I would comment on your comment that Mexicans saw their life savings decrease by half in the last week. That is only if they intend to bring their money into the United States. We hope that they are going to keep their money at home and invest it in their own economy.

In these hard times, I think we really have to remember that in the years since the Mexican Revolution, the Mexicans have been able to keep peace in their own society, they have been able to insure a respect for civil liberty for their own people, and it is very important that we not shake this system.

The United States' stake in the success of Mexico in managing its economic challenge is simply enormous. Mexico is a major trading partner of the United States. Thousands—thousands—of United States jobs depend on exports to Mexico.

A perfect illustration of this is what happened in 1983, and the years immediately following.

United States exports to Mexico fell from a high of an annual rate of $17 billion, to a low of an annual rate of $9 billion. That fall happened in the short space of about 1 year. That represented a very heavy loss for the United States of America as well as for Mexico.

Now, it is no secret that in all nations, societal problems increase in bad times. So it is no surprise that problems of illegal immigration and drug trafficking are exacerbated by Mexico's economic problems.

I would only note in passing that there has been an unfortunate tendency recently to single out Mexico with respect to both of these problems.

Tragically, criminally, drugs and uninvited guests enter the United States from countries all over the globe. We even have a little cottage industry within the United States that contributes to the problem.

Mexico is, unfortunately, only one contributor among many to problems that we face in both of these areas.

I think, as Senator Helms has suggested, that we have a strategic stake in the well-being of a valued neighbor. Mexico is a significant player in a region that is vital to the United States, and no conceivable United States interest is served by the perpetuation of Mexico's difficulties.

I should add that in spite of what I conceive to be our enormous commercial and political stake in Mexico, we have not invested a fraction of the interest and concern in Mexico that we have devoted to much smaller countries, such as El Salvador and Nicaragua. I think that that is unfortunate.

So this hearing is in the nature of an inquiry by one concerned neighbor as to the difficulties being faced by another neighbor. We hope to be able to obtain a better understanding of Mexico's problems, perhaps to elicit insights on how we may contribute to resolving those problems.

I think we all recognize that in the final analysis, the resolution has to come through the hard work of the Mexicans themselves. But if there are useful ways in which the United States can be of assistance, then we should be alert to them.

In the first analysis, our duty is concerned with the interests of the United States of America, how to defend them, how to promote them.

In my judgment, the way to promote our national welfare and interest regarding Mexico is by direct negotiation based on respect for one another. I would hope that these hearings would establish a proper foundation for such a dialog.

Senator **HELMS**. Thank you, Senator.

Senator Zorinsky.

Senator **ZORINSKY**. Mr. Chairman, I have no opening statement.

Senator **HELMS**. Senator Evans.

Senator **EVANS**. Thank you, Mr. Chairman.

Let me just say very briefly that I am sorry, especially with the attention created by the past hearing, that I did not have a chance to appear and to listen personally. I have attempted to read some of the testimony, and I would suggest that some of the testimony by some members of the administration was imprudent, and probably not appropriate.

As a country, I think we for too long have focused much of our attention in this hemisphere on Nicaragua. With all of its admitted problems, it pales into insignificance against the intermittent attention we have paid to our closest neighbor. It is time we paid more attention and more heed on a more continuous basis to Mexico.

Mexico is a large and proud country. There is no comparison between the size, the importance, the closeness of Mexico to the United States and the problems that permeate Nicaragua.

It is easy to bluster about American taxpayers and what we will or won't do. But what would be the result of a collapsed Mexican economy?

We would instantly forget Nicaragua and most of the rest of the world. A far greater series of problems would be created on our southern border, and, I might add, on both sides of our southern border.

I think it is terribly important for us to listen and to seek informed, creative, constructive ideas that will lead to a rejuvenated Mexican economy. A strong and friendly Mexico will insure the continuation of the peaceful and open border which we have enjoyed for much more than a century.

Mr. Chairman, I would like to suggest that we add to the record an important editorial in The Economist of April 5, 1986, entitled "Awkward Neighbors." I think it states the problem from a different perspective, from a European viewpoint. This is an important perspective as we deal with these questions of our economic relationships with Mexico.

[The information referred to appears in the appendix.]

Senator **Helms**. Thank you, Senator.

The first panel is listed to include Senator Wilson, of California, who will not be able to be here because he is tied up in the Armed Services Committee this morning. But he wants to participate next week, at which time the distinguished former Ambassador to Mexico from the United States, Jack Gavin, will appear.

So we invite now Senator Phil Gramm and Congressman Jim Kolbe of Arizona to come to the table as our first panel.

Senator Gramm is chairman of the United States-Mexico Interparliamentary Council. We welcome him and the distinguished Congressmen. We thank you for appearing.

Senator Gramm.

STATEMENT OF HON. PHIL GRAMM, A U.S. SENATOR FROM TEXAS

Senator **Gramm**. Thank you, Mr. Chairman.

Mr. Chairman, I would like to talk very briefly about the state of the Mexican economy. I would like to talk about debt service and debt service ability.

But first let me begin by talking about the stake of the United States in this whole issue. Having just come back from Colorado Springs, and Senator Zorinsky was there with me, much of the focus of discussion concerning your previous hearing centered around whether or not it was appropriate for the United States, through the Congress, to be holding hearings on what were perceived to be and considered to be internal affairs of Mexico.

So, I would like to preface my comments this morning by simply outlining what the stake of the United States is in the economic problems of Mexico.

No. 1, I do not think it is an overstatement to say, given the relative states of economic development, that there is no nation more vital to the well-being of the United States directly, in terms of impact on its people, than Mexico.

Mexico is our third largest trading partner. We share a 2,000 mile common border with Mexico, half of which is a common border between Texas and Mexico. In terms of the debt, which is very much in the news and of great concern to this committee, the United States holds about a quarter of that debt, and holds three times as much as anybody else.

Trade directly between our two countries is very much affected by economic policy in Mexico.

In my own State, we have had a virtual depression along the border because of the decline in the value of the peso and because of a collapse of trade.

So I think it is clear, Mr. Chairman, in discussing these issues, that we are not prying into the internal affairs of another nation, but we are, instead, talking about that nation's problems as they relate to the well-being of the American people.

It is in this context that I would like this morning to discuss the problem.

The problem with the Mexican economy is a pretty easy problem to define; it is a very difficult problem to do something about.

Since 1970, the percentage of GNP in Mexico expended by the Government has doubled, from roughly 26 percent of GNP in 1970 being absorbed by Government, now up to over 50 percent. During that same period, the number of industries that were nationalized and run by the Government in the parastatal system has grown from less than 100 to over 1,000.

Today, the Government controls the economy of Mexico and allocates capital, often on a preferential basis, where the rate of interest one gets on a loan depends on the position he holds in government and whether or not he is prominent in the governing party of the country. Clearly a great deal of preferential treatment exists in the allocation of capital.

Mexico currently has a foreign debt of about $100 billion. Much of that debt was incurred not to invest in the private sector of the economy, but to invest in these 1,000 different firms that are part of the Government-run economic system.

In fact, over half the debt went to a handful of large, nationalized industries.

Now we are going to have a great debate in the Congress because of the importance of Mexico's servicing of this debt as to what Federal policy should be and what it should do.

Let me say, Mr. Chairman, that I think we have a great stake in helping Mexico solve her problem. We have a great stake because we share a common border with Mexico and we share a common future with Mexico. But I think the sad reality is, while Mexico has been hit with external shock—very high interest rates, a collapse in world oil prices—that many of the problems in Mexico are self-produced.

We had a survey recently of the Fortune 500 companies, and they were asked a simple question: If Mexico repealed its ban on foreign ownership, which requires that 51 percent of the ownership of any new investment be Mexican owned, what would that do to their investment decisions in Mexico? Fifty-two percent of the Fortune 500 companies that responded said that if Mexico would allow foreign investment on the same basis that Japan, Korea, Taiwan, and Hong Kong do, they would either institute a new investment program or they would expand their existing investment.

Now, we are seeing an effort in Mexico to institute change. Some of that effort represents great political courage by its leadership. But, at the same time, we see dual statements being made—one statement being made to international media about selling all parastatals, privatizing the economy, bringing the deficit under control, moving toward the promotion of exports, and opening up the economy to more trade and investment; and at the same time we see statements made for local consumption that indicate an exactly opposite policy.

Mr. Chairman, in this area, we do not have to rely on what people say. There is a clear market test of whether or not you are making progress in terms of enhancing the environment for private investment. That market test is what is happening to the amount of capital coming into and leaving the country? It is by this real world market test that the global economy is flunking the

Mexican Government in terms of what they are doing—not what they are expressing as an intended policy; not the action that has been taken that in some cases represents real political courage; but the bottom-line action that is being undertaken.

Last year, by the best figures that we have, between $3 and $6 billion of Mexican capital left the country. Despite the fact that there are prohibitions against capital exports, despite the fact that that can produce not only difficulties with the government but social scorn, people have taken clear action to move their money out of Mexico. In fact, some of our data indicate that as much as $50 billion of Mexican capital has flown from Mexico into the United States.

At the same time that between $3 and $6 billion were leaving Mexico last year, net foreign investment was less than $500 million.

Now any time that you are seeing that kind of capital flight, you know that something is wrong in the economy.

I think it is clear, Mr. Chairman, that, even if we set out the policy that we were going to bail out the banks and, therefore bail out Mexico and its current debt problem, unless they make changes internally to make their economy competitive and efficient, there is not enough money in the taxpayers' pocket to permanently bail out Mexico.

In fact, action on our part to bail out the banks, to bail out the politicians so that they do not have to make hard and difficult decisions, would not only waste the money of the American worker, but would also allow the Mexican politicians to put off the difficult decisions that have to be made to deal with their own problem for the long run.

What they have to do to make their economy work is to reform their economic structure. This will not send oil prices up. This will not change world interest rates. But it will help them deal with those problems, and in the absence of those changes, those problems cannot be dealt with by the American taxpayer.

Interestingly enough, not only can't we deal with the problem by ourselves, but if the Mexicans will deal with the problems they have by making hard decisions, they won't need our help. If they will do what needs to be done, they can solve their problem on their own; and if they won't do it, we don't have enough money to solve it for them.

Now, what kind of changes are we talking about?

No. 1 is opening up Mexico for investment. American capital would flow into Mexico given an opportunity to do it on anything like a competitive basis. American capital in the post-World War II period has rebuilt Europe, rebuilt Japan, built Korea and Taiwan, and Hong Kong into economic giants. That same capital could do the job in Mexico. But it is not going to Mexico when it has to have 51 percent Mexican ownership, when it faces capital controls, when it faces price controls, when it faces blatant political favoritism in the marketplace.

The difficulty that Mexican politicians have is not dissimilar to our own difficulties. They have to make the hard decision about letting foreign entrepreneurship and capital into the country to compete against existing economic forces. Opening up trade, allowing their own consumers to have better quality goods at lower prices will make their own exports more competitive.

In one of the great paradoxes, we have a booming maquiladora system, where American capital and Mexican labor are working together producing some of the most competitive products on Earth. Yet, in many cases, the Mexican Government will not allow those products to be sold in the Mexican economy, where they could become components of Mexican goods that could be exported to the United States and elsewhere.

I think, finally, we have to recognize that what we have to offer in dealing with this problem is not simply our money. I sometimes feel, Mr. Chairman, that we in the United States are like a rich kid who has suddenly found himself in the middle of a slum with a cake, and everybody looks at that cake and they would like to have a piece of it. Now, whether they knock us on the head and take the cake, or whether we cut off little pieces and try to buy them off with it, the reality is that the cake is relatively small compared to the needs and wants of a hungry world. What we have to share is not the cake, but the recipe that we used in baking that cake.

I think that is what we really have to offer to Mexico and to the rest of the world.

I can tell you from my 2 years of experience, Mr. Chairman, as a concluding comment, that it is very difficult for Mexico to accept our economic system. It is difficult for two reasons.

First, the more free enterprise capitalism you have, the less political power you have. The plain, sad truth is that the PRI has its economic base in government control of industry and investment and government prevention of competition. It is going to take very great courage for a Mexican leader to stand up to those special interest groups and make decisions that are in the interest of the future of Mexico and its people.

I think President de la Madrid has shown great courage. But I think in trying to take the steps that have to be taken, we all know from our own experience in much less difficult problems that it is often very difficult to tell special interest groups no, especially when they have great political power.

So, I think, basically, that is the first problem we face: that to do the right thing, to strengthen their economy, to allow them to service their debt, to grow, to provide jobs for their people, they are going to have to make difficult political decisions.

I think, second, that I never realized, until I started working in the interparliamentary movement, how much latent resentment there is of this Colossus of the North; that somehow, in trying to be good neighbors and trying to give advice, we often come across as being dictatorial.

I was amazed in listening to our colleagues in the Mexican House and Senate talk about how they had a different sociological system than we do; that what will work for them economically is different than what will work for us.

Now, some of that obviously is an effort to shield themselves from a political problem; but I think it is clear that many of them believe it.

I would simply like to leave you with two points.

No. 1, when we have nations as diverse as France and Communist China, who have found that they cannot make collectivism work, it is unlikely that Mexico is going to do it. I firmly believe that their future well-being, as well as our own, depends on a series of difficult decisions that only they can make in trying to promote their own internal well-being.

We can encourage them. We can offer to help based on the action that they take. But, ultimately, they have to solve their own problem. And, in an absence of willingness to do that, our money cannot solve their problem.

Second, we have a great paradox in that we have $50 billion of Mexican capital in the United States—that is $10,000 for every Mexican laborer who has come into this country as an illegal alien. Mexican capital and Mexican labor come into the United States, to be combined in an economic system that is obviously more attractive to capital and labor than the system in their own country. It is a great paradox that if we simply could induce them to change their system, American investors would beat their door down trying to invest money there, trying to generate jobs there, trying to increase their well-being.

So I think the well-being of Mexico is critical to us. I, for one, stand ready to do anything that I can to try to help Mexico. But I come to you with, I think, a sober reality, which is we cannot help them do the things that will solve their problem. They have to do those things themselves. And, if they are not willing to do them, there is nothing that we can do with our money that will substitute for the real economic reforms that have to be undertaken.

Senator **Helms**. Thank you very much, Senator, for a splendid statement.

Congressman, we would be delighted now to hear from you.

STATEMENT OF HON. JIM KOLBE, A U.S. REPRESENTATIVE FROM ARIZONA

Representative **Kolbe**. Thank you very much, Mr. Chairman.

I will just summarize some of the sections of my statement and would ask that my entire statement be placed in the record, if that is acceptable to you.

Senator **Helms**. It is.

Representative **Kolbe**. I appreciate very much the opening remarks that have been made by all the members of the subcommittees, as well as Senator Gramm. I think that they are very constructive statements.

I had the pleasure of also serving as a member of the United States delegation to the United States-Mexico interparliamentary conference, with Senator Zorinsky and Senator Gramm, among others, just 10 days ago, in Colorado Springs.

A world reknown writer, Carlos Fuentes, from Mexico, said recently that what the United States does best is to understand itself; what it does worst is to understand others.

Mr. Chairman, we can ill afford not to understand what is happening in Mexico and what it portends for this country, as well as for Mexico. So this hearing is, indeed, very timely, and I commend you, as the chairmen of these subcommittees, for the holding of this hearing.

While the current turbulence between Mexico and the United States certainly produces a measure of stress between our two Governments, it also opens the door for an honest assessment of the problems that exist and to a search for real solutions.

A moment's reflection will quickly bring to mind a number of the critical issues that confront the United States and Mexico together. Drug trafficking, illegal immigration and environmental concerns are but a few of the problems that we share.

There is no question that these specific problems contribute to the overall crisis of economic and political instability in Mexico.

When a combination of economic disasters and the failure of economic policies strike our neighbor to the south, these other issues take on an added importance for us. But I believe that, fundamentally, all of these issues are symptoms of the economic crisis that Mexico is facing.

Too often and too long, our attitude in the United States toward Mexico has been one of benign neglect, as Senator Mathias pointed out in his opening statement.

In my part of the country, as well as in Senator Gramm's part of the country, where Arizona shares a 340-mile border with Mexico, this kind of neglect is impossible. The bonds are too great.

For us, Mexico represents neighbors, friends, business partners and relatives, with whom we share a multitude of common concerns. To build a structural or legal wall between our two nations would be like trying to wall off New York from New Jersey.

But it would be no less foolish or damaging to build an emotional wall, with racial slurs, patronizing suggestions of quick fixes and threats from Big Brother. Those of us who live near the border are also guilty of taking for granted the deep relationship which exists between our two countries. That is a serious mistake. Like the relationship between husband and wife, the relationship between two neighboring nations requires constant attention and hard work.

The crisis facing Mexico carries with it the potential for wreaking great political and economic havoc in our own country. We must never turn a blind eye when the conditions in Mexico begin to affect our own people. What is at stake for my constituents is a delicate symbiosis involving economic, social, and blood relationships.

What is at stake for the Nation as a whole is the future of our third largest trading partner, as Senator Gramm pointed out, and the very security of our borders and of our hemisphere.

We must also remember that there are no two nations in the world that share a common border that have such a vast economic disparity as Mexico and the United States.

Keeping this in mind, it becomes clear what our economic relationship with Mexico means to us and to them.

Despite the enormous economic and political pressures which Mexico finds itself under today, and which we in Congress all too often tend to forget or choose to ignore, the Mexican Government has demonstrated a genuine spirit of conciliation and cooperation in its economic relationship with the United States. They have attempted to achieve International Monetary Fund stipulated targets for deficit reduction through tight-fisted fiscal policies that have been very unpopular politically at home. They have expressed their interest in divesting themselves of 236 out of 840 state-run businesses, though this reform has been slow and sporadic.

They are experiencing real success with their border industrialization program, the in-bond or maquiladora industry. It experienced a growth of 16.4 percent in 1985, and replaced tourism as the number two foreign exchange earner after all.

This is a real achievement when we consider, as you, Mr. Chairman, pointed out that Mexico's economy has either been stagnant or in retreat for the last several years.

They are also pursuing methods to establish trade relationships with the rest of the world—currently negotiating, as you know, to join the General Agreement on Tariffs and Trade, or GATT. They are taking steps to weaken or dismantle their destructive import substitution policies.

All of these moves are fraught with political difficulties. They demonstrate a real commitment to economic modernization and liberalization. The question which now must be asked is whether these moves been made too late in the game to be of any help.

I believe it bears repeating that, in discussing possible solutions to the crisis in Mexico, we must be sure to approach the situation as partners who are offering to lend a hand to an important economic and political ally. From our perspective, two main areas should be examined for this kind of opportunity.

Mexico should be encouraged to liberalize its treatment of foreign investors. The law in Mexico which limits foreign investment to 49 percent ownership of an enterprise is an obstacle, in my opinion, which hinders Mexico's ability to attract foreign exchange. We all recognize the political difficulties Mexico faces in making a change in that policy.

While Mexico has taken steps to ease this restriction, as its acceptance of investment by IBM demonstrates, their debt burden will require a much more liberal attitude toward foreign investment.

Currently, Mexico has the lowest share of direct foreign investment of any large, Western economy. Only 4.5 percent of their total investment is from other countries.

President de la Madrid has expressed willingness to improve this situation, but the current situation gives urgency to the need to translate words into deeds.

There is also much the United States can do to help continue the development of the border region. We should approach border issues on both sides in terms of reciprocity we can provide for one another. We need give and take, not a tug of war. The United States should continue to commit its support to the maquiladora program, which provides us with finished goods at reasonable prices and provides Mexico with jobs and foreign exchange.

I might point out, Mr. Chairman, that this does not, in my view, mean lost jobs to the United States, but jobs that are actually repatriated from Asia and other offshore nations to our border regions, and creates jobs along our border.

The maquiladora establishes a buffer zone of prosperity, if you will, and that can help ease the tension between citizens north and south of the border. In time, this program can be expanded into Mexico, with a great latitude of ventures that can be established.

For its part, Mexico must face the political problems which result from disproportionate economic development between the border regions and other regions of Mexico. Population pressures and the already overwhelming social and economic difficulties confront border administrators. But the solution is not to restrict development of the border region. Rather, it is to understand and address the problem these pressures create, and for Mexico to devote sufficient resources to develop the infrastructure in these areas to be able to handle the increased industrial demands.

Continued success of the maquiladora program will require a greater degree of cooperation between Mexico and the United States on environmental questions.

Just 10 days ago, I attended the dedication of the new copper smelter at Nacozari, in Sonora, just 60 miles south of the border between Arizona and Sonora, and in very close proximity to similar smelters at Cananea, Sonora, and Douglas, AZ.

Taken together, these three smelters constitute a source of sulphur dioxide emissions greater than all the other sources west of the Mississippi River. That poses an unacceptable level of emissions for the citizens of either Mexico or the United States. But I am pleased to report that significant progress is being made toward a solution of this potentially serious problem.

Ultimately and inevitably, the success of the border economic program should lead our countries to consider establishing a free trade zone. That is going to have to be done not overnight, but step by step. I recognize that it is not going to come easily or quickly, and not without considerable political courage being shown on both sides of the border.

But as we have used this concept to demonstrate in a very visible way the special relationship which exists between Israel and the United States, so, too, can we demonstrate the very special economic relationship which exists between the United States and our neighbor to the south.

The administration has recently announced that it intends to begin a major effort to reassess its policies with regard to Mexico and to provide better coordination between agencies so that we might have a coherent policy. I applaud this effort.

For Congress as well, this should be our goal and the focus of our concerns.

Thank you very much, Mr. Chairman.

[The prepared statement of Representative Kolbe follows:]

Prepared Statement of Congressman Jim Kolbe

Representative Kolbe. Mr. Chairman, I want to commend the Subcommittees on Western Hemisphere Affairs and International Economic Policy for conducting this hearing on Mexico's economic situation. I can think of few issues which have greater consequences for this Nation than our relations with and the future of Mexico.

A world-renowned Mexican writer, Carlos Fuentes, said recently: "What the United States does best is to understand itself. What it does worst is understand others." Mr. Chairman, we can ill-afford not to understand what is happening in Mexico and what it portends for this country as well as for Mexico. So this hearing is, indeed, very timely. And while the current turbulence between Mexico and the United States certainly introduces a measure of stress between our two Governments, it also opens the door to an honest assessment of the problems that exist and to a search for real solutions.

A moment's reflection will quickly bring to mind a number of critical issues that confront the United States and Mexico. Drug trafficking, illegal immigration and environmental concerns are but a few of the problems we share. There is no question that these specific problems contribute to the overall crisis of economic and political instability in Mexico. When a combination of economic disasters and the failure of economic policies strike our neighbor to the south, these other issues take on added importance for us. I, therefore, believe that fundamentally all of these issues are symptoms of the economic crisis that Mexico is facing. In searching for solutions to these problems, I am convinced that our efforts are best directed at working towards relieving the severe economic stresses they are experiencing.

Too often and for too long, our attitude in the United States toward Mexico has been one of benign neglect. The wall of cultural and social differences between the two nations overwhelms our ability or willingness to comprehend, so we wallow in our mutual and comfortable ignorance. In my part of the country, where Arizona shares 340 border miles with Mexico, this kind of neglect is impossible. The bonds are too great. For us, Mexico represents neighbors, friends, business partners and relatives with whom we share a multitude of common concerns. To build a structural or legal wall between our two nations would be like trying to wall off New York from New Jersey.

But it would be no less foolish—or damaging—to build an emotional wall with racial slurs, patronizing suggestions of quick fixes and threats from big brother. Those of us who live near the border are guilty of taking for granted the deep relationship which exists between our two countries. That is a serious mistake; like the relationship between husband and wife, the relationship between two neighboring nations requires constant attention and hard work.

Let us make no mistake about it. The crisis facing Mexico carries with it the potential for wreaking great economic and political havoc in our own country. I have no desire to interfere in Mexico's sovereignty. But we must never turn a blind eye when the conditions in Mexico begin to affect our own people. What's at stake for my constituents is a delicate symbiosis involving economic, social and blood relationships. What's at stake for the nation as a whole is the future of our third largest trading partner and the very security of our borders and of our hemisphere.

We must also remember that no two nations in the world, sharing a common border, have such a vast economic disparity than exists between Mexico and the United States. Keeping that in mind, it becomes even clearer what our economic relationship with Mexico means to us, and to them.

In assessing the current situation in Mexico, it is difficult to be optimistic. I won't pretend to be. In pursuing solutions where the United States can play a constructive role, we shouldn't automatically assume that our initiatives will be rejected. I am convinced that if such initiatives are approached in the spirit of partnership, President de la Madrid and his administration will be anxious to cooperate. It is in their own best interest, and the best interest of their people.

In our dealings with Mexico, let us not forget that very strong and complex political pressures are at work in that country as well. On one level, a superficial level, we have a paternalistic ruling party which is struggling to maintain its preeminent position. Within that framework are individuals who are attempting to steer their country along a moderate and reasonable course, to deal effectively with economic problems, while also working to maintain political stability within their borders. Disaffection is rampant with the Institutional Revolutionary Party (PRI)—from their middle class government bureaucrats (National Confederation of Popular Organizations—CNOP), to their agrarian sector (CNC). As the stability of this coalition weakens, the Government's ability to respond effectively to its economic problems is diminished.

Despite these pressures, which we in Congress either tend to forget or choose to ignore, the Mexican Government has demonstrated a genuine spirit of conciliation and cooperation in its economic relationship with the United States. They have attempted to achieve international monetary fund stipulated targets for deficit reduction through tight-fisted fiscal policy that has been very unpopular politically. They have expressed their interest in divesting themselves of 236 out of 840 state run businesses, though this reform has been slow and sporadic.

They are experiencing real success with their border industrialization program, the in-bond, or Maquiladora industry. It experienced a growth of 16.4% in 1985 and replaced tourism as the number two foreign exchange earner after oil. Continued growth is projected in this sector in 1986. This is a real achievement when we consider that the rest of the Mexican economy has been stagnant or in retreat. They are also pursuing methods through which to establish trade relationships with the rest of the world. They are currently negotiating to join the General Agreement on Tariffs and Trade (GATT), and they are taking steps to weaken or dismantle their destructive "import substitution" policies.

These moves are fraught with difficulties. They demonstrate a real commitment to economic modernization and liberalization. The question which now must be asked is: Have these moves been made too late in the game to be of any help?

The problems in Mexico are easy to identify. They have lost billions of dollars in potential revenues from the international oil price decline. They are struggling to control the flight of capital from within their borders. They are facing increased social pressures as a result of natural disasters and fiscal austerity programs that have been in place since 1982. Their domestic industries cannot compete on the international market. Meat and dairy products are literally unavailable, and the price of tortillas, the staple of the Mexican diet, has doubled in the last two years. The peso exchange rate is in a free fall. They are struggling under the weight of massive debt obligations upon which the fate of several U.S. banks hinge. In the face of all this, we must be prepared for the inevitable, the declaration of a moratorium on further debt payments until this crisis eases.

I believe it bears repeating that in discussing possible solutions to the crisis in Mexico, we must be sure to approach this situation as partners who are offering to lend a hand to an important economic ally. From our perspective, two main areas should be examined for this kind of opportunity. Mexico should be encouraged to liberalize its treatment of foreign investors. The law in Mexico which limits foreign investment to 49% ownership of an enterprise is an obstacle which hinders Mexico's ability to attract foreign exchange. While Mexico has taken steps to ease this restriction, as its acceptance of investment by IBM demonstrates, their debt burden will require a much more liberal attitude toward foreign investment. Currently, Mexico has the lowest share of direct foreign investment of any large western economy—only 4.5% of their total investment is from other countries. President de la Madrid has expressed willingness to improve this situation, but the current situation gives urgency to the need to translate words into deeds.

There is also much that the U.S. can do to help continue the development of the border region. We should approach border issues, on both sides, in terms of reciprocity we can provide for one another. We need give-and-take, not tug-of-war. The U.S. should continue to commit its support to the Maquiladora Program, which provides us with finished goods at reasonable prices and provides Mexico with jobs and foreign exchange.

The Maquiladora establishes a "buffer zone" if prosperity, if you will, which can help ease the tensions between citizens north and south of the border. In time, this program can be expanded farther into Mexico, with a greater latitude of ventures that can be established. For its part, Mexico must face the political problems which result from disproportionate economic development between the border region and other regions of Mexico. Population pressures add to the already overwhelming social and economic difficulties which confront border administrators. But the solution is not to restrict development of the border region. Rather it is to understand and address the problems these pressures create, and for Mexico to devote sufficient resources to develop the infrastructure in these areas to be able to handle the increased industrial demands.

Continued success of the Maquiladora Program will require a greater degree of cooperation between Mexico and the United States on environmental questions. Just ten days ago I attended the dedication of the new copper smelter at Nacozari, Sonora, just sixty miles below the border and in close proximity to similar smelters at Cananea and Douglas, Arizona. Taken together, these three smelters constitute a source of sulphur dioxide emissions greater than all the other sources west of the Mississippi River combined. That poses an unacceptable level of emissions for the citizens of either Mexico or the United States. But I am pleased to report that significant progress is being made toward a solution of this potentially serious problem.

Ultimately and inevitably, the success of the border economic program should lead our two nations to consider establishing a free trade zone. I recognize that this will not come easily or quickly and not without considerable political courage being shown on both sides of the border. But as we have used this concept to demonstrate in very visible way the special relationship which exists between Israel and the United States, so too can we demonstrate the very special economic relationship which exists between the United States and our neighbor to the south.

But it is Mexico's debt problem which looms darkest of all. Current proposals to restructure this debt, and to provide needed assistance to help meet current obligations, should be pursued vigorously. This should be done, however, with the understanding that such proposals will succeed only as a short term measure to ease the current crisis environment. The longer term answer is to allow liberalized economic policies to take effect, to unshackle the great potential that lies within the people of Mexico, and to help Mexico emerge from the shadow of the United States as an independent, democratic, sovereign nation capable of standing on its own, a healthy player in the world economy.

The administration has recently announced that it intends to begin a major effort to reassess its policies with regard to Mexico and to provide better coordination between agencies so that we might have a coherent policy. I applaud this effort. For Congress as well, this should be our goal, and the focus of our concerns.

Senator HELMS. Thank you very much, Representative Kolbe.

Gentlemen, we appreciate your coming.

Now we will proceed with panel No. 2, which consists of precisely one gentleman.

Senator MATHIAS. Before we do that, since we have Phil Gramm here, and he has demonstrated his command of these problems of public fiscal policy, you mentioned the situation with respect to the flight of capital. That is a terribly important subject and it is a very difficult subject. It is not unique to Mexico.

I remember a couple of years ago, when the Kissinger Commission met with President Monge of Costa Rica. He was complaining of the lack of capital in Costa Rica for economic expansion. We said well, Mr. President, by definition you have a rich country, where is your money? He said that it was all in Miami.

Of course, that is the case with many countries in the world now.

What do you do about the flight of capital? I think that is an important subject to probe for just a minute.

Senator GRAMM. Let me say, Mr. Chairman, that capital will go where there is an environment for it to grow. All you have to do to attract capital is to provide an environment in which property rights are respected, an environment in which people can invest and reap some reasonable share of the returns generated by that investment. You have to provide an environment in which you have relatively free exchange so that capital can be used in an efficient way.

I think if we have learned anything in the post-World War II period, it is that economic growth can occur anywhere those basic conditions are met.

I would take South Korea as a perfect example. We all know, we are all painfully aware, that South Korea has not reached the level of political maturity that we would like. But, when the war ended in South Korea, the country was in ruins, per capita income was less than $50 a year, and all the resources were in the north. The general assumption was that we had a basket case economy on our hands that would be a burden on us for the foreseeable future.

It has turned into a great economic miracle because it basically provided an economic environment that has attracted capital from all over the world. The economy is booming.

Mexico could easily do the same thing if they provided the environment. And even if their own capital came back, they would pay off half their debt.

Senator MATHIAS. What about the enormous exchange of capital—we don't normally call it flight of capital—the transfer of capital from Europe to the United States, which is going on on a constant basis? In Europe, you have conditions which come close to your definition, and yet you still have enormous flight of capital from Europe.

Senator GRAMM Well, there are two forces at work. No. 1, because the exterior of the Common Market is still relatively protected, because we have greater freedom of capital in the United States and because we have the highest real interest rates in the world——

Senator MATHIAS. Ah-hah.

Senator GRAMM [continuing]. What is happening is that capital is coming into the United States.

I can remember in graduate school reading an old fellow named Walter Badgett, who wrote that 8 percent will bring gold from the Moon.

Senator MATHIAS. And 18 percent will bring it even a lot farther.

Senator GRAMM. Yes, 18 will bring it from Mexico and from everywhere else.

But just look at the interest rate in Mexico. In nominal terms, it is much higher. What is attractive here is the real rate, given the stability.

So, my point is capital is always moving. But everything I have heard—that is, we heard the discussion here about the maquiladoras. I have talked to Japanese businessmen, to American businessmen, to Korean businessmen about the Mexican labor. They tell me that the maquiladora plants, American management by and large, but with some Japanese and other management, such as German, and with Mexican labor, provide some of the most efficient production in the world.

So the resources are there. I would argue that what is missing is the system. As we know, that is the most difficult thing to produce and sustain.

Senator MATHIAS. I certainly salute you for your efforts in reducing the budget deficit in this country and therefore the interest rates of this country. But we are still providing an enormous magnet for flight of capital from other countries.

Thank you.

Senator HELMS. Thank you, Senator.

And thank you, gentlemen.

Now, the next panel will consist of Hon. David C. Mulford, Assistant Secretary of the Treasury for International Affairs.

Please come forward, sir, and proceed.

If you wish to file your entire statement and summarize, or whatever you wish to do, is fine.

STATEMENT OF HON. DAVID C. MULFORD, ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Mr. MULFORD. Mr. Chairman, I have come up this morning with one statement, a relatively brief one, as you asked for, which I would like to read through, please. It will take about 10 minutes.

Senator HELMS. Very well. But first, I would ask that you pull the microphone a little closer to you.

Mr. MULFORD. Yes, sir.

Mr. Chairman, I welcome the opportunity to appear before these subcommittees to discuss Mexico's economic situation. My remarks today will focus on the present state of the economy and address the major problems facing Mexican policymakers.

I will review the developments leading to the 1982 financial crisis and the measures taken by the Mexican Government to cope with it.

This provides the necessary context for an understanding of how Mexico is managing its present problems.

Mexico and the United States share a close economic and financial relationship. Mexico is our third largest trading partner. U.S. direct investment in Mexico is estimated at $5 billion with the presence of some 2,900 U.S. firms.

Although Mexico has attracted substantial equity capital from other nations, the United States remains the largest single source of private foreign direct investment.

Mexico has also become a major player in the world economy. It is the 12th largest economy and the 2d largest LDC debtor, with an estimated $97.4 billion outstanding in obligations.

Of this, nearly $74 billion is owed to the commercial banks, including $24.4 billion to U.S. banks, approximately one-third.

This has made Mexico one of the focal points in our debt strategy.

We enjoy a close working relationship with Mexican financial officials who have repeatedly demonstrated Mexico's commitment to being a responsible member of the international financial community.

Unlike a number of other nations, Mexico has not permitted significant accumulation of payments arrears and the adjustment of its external accounts after 1982 was impressive. Through determination and perseverance, Mexico bcame a model adjuster in the post-1982 period, as it eliminated its current account deficit, even in the face of sharply reduced economic output.

The sacrifices of the Mexican people after 1982 have made the impact of the sudden oil price collapse in 1986 all the more onerous. This year will be the third out of the last five that Mexicans will have to endure economic contraction.

Against this background, the rapid adjustment required by the sudden loss of oil revenues becomes all the more difficult.

Mexican officials are well aware of the dimensions of their current problems and the need for early resolution. The Government has already taken numerous steps to deal with these problems, including actions to cut spending, sell off state enterprises, and shift debt into equity.

These difficult steps have not received the recognition they deserve and Mexico has not been given credit due. When it comes to Mexico, there is a tendency to be quick with criticism and cautious with praise.

Mexico's present situation can only be understood and assessed against the background of the 1982 crisis and events since then. The oil windfall of the late 1970's was used to spur economic growth, with only modest efforts to diversify the economy's export base. In this regard, Mexico behaved no differently than most other oil exporters. The rapid pace of economic growth, which averaged

8.5 percent from 1978 to 1981, created serious structural bottlenecks. As a result, inflation began accelerating, reaching 99 percent in 1982, compared with 29 percent in 1981.

Instead of dealing with the root causes of these problems, Mexico resorted to additional foreign borrowing. In 1981 alone, Mexico's foreign debt increased by $18 billion.

In part, this was because the commercial banks continued to lend and at low spreads. Real interest rates in the late 1970's were negative. Thus, as was the case with other large debtors, Mexico's continued borrowing from abroad was not surprising.

However, most of Mexico's external debt carried floating interest rates. As interest rates peaked in 1981, the real interest rate on the foreign debt became sharply positive and Mexico's debt service increased substantially.

With the world recession, softening oil prices, and Mexico's own economic performance, banks became concerned about Mexico's creditworthiness. They began to reduce their lending to that country and, before long, the probability of a financial crisis had become very high.

Mexico's announcement over the weekend of August 13, 1982, an announcement that we all knew was coming and which had been understood in advance, that it was suspending payments on its external obligations, caused a near panic in financial markets. There were widespread fears that other major debtors would follow suit and cause irreparable damage to the financial system.

However, with the close cooperation of official and private creditors and the IMF, Mexico quickly implemented a major stabilization program, and serious disruption to the financial system was avoided.

The economic stabilization program that the De la Madrid administration undertook in the wake of the 1982 crisis brought Mexico's external accounts under control in a relatively short time. However, as was the case with a number of debtor nations in the first round of the adjustment to the new financial and economic conditions of the 1982–84 period, the degree of internal adjustment accomplished by Mexico was limited.

This was, in part, due to the high political and economic costs associated with it.

Following the 1982 crisis, the Mexican Government took some very tough measures on the fiscal, monetary, and foreign exchange fronts. As a result, economic activity dropped by 0.5 percent in 1982, and another 5.3 percent in 1983; imports were reduced by 40 percent in 1982 and a further 45 percent in 1983. The current account swung from a deficit of $6 billion in 1982 to a surplus of over $5 billion in 1983. During this period, because of its good progress on the external side, Mexico was seen by many as a model adjuster.

In 1984, the economy grew by 3.5 percent and the current account registered surplus of $4 billion, despite a 31-percent growth in imports. But the external adjustment began to slow late in the year since further improvement on the balance of payments could only come from further growth and improved export performance.

While Mexico's imports dropped by two-thirds between 1981 and 1983, a development that contributed to our own growing trade deficit, its exports grew by less than 11 percent during that period.

This disparate performance reflects the fact that Mexico was plagued by economic and structural problems rooted in its past. Having followed a policy of import substitution since the 1940's, Mexico had not by the early 1980's sufficiently diversified its export base and thus its capacity to expand nonoil exports quickly during this period was limited.

In 1985, Mexico suffered an 11-percent decline in oil receipts that was exacerbated by declines in nonoil exports due in part to an overvalued exchange rate for much of the year. In an effort to sustain the economic growth, the Government adopted expansionary fiscal and monetary policies despite the lower oil revenues.

While growth was maintained at about the 1984 pace, inflation accelerated as the Government monetized a substantial portion of the Government deficit.

Mexico's attempt to maintain economic growth in the face of declining oil revenues made it particularly vulnerable to the 50-percent drop in oil prices that took place in the short space of 6 weeks in early 1986.

Since approximately half of Mexico's Government revenues are based on oil exports, the drop in prices translated into a 25-percent real decline in Government revenues.

Coming as it did after 4 years of economic adjustment, this traumatic contraction was not only economically painful but politically demoralizing.

The problem now facing Mexico is how to undertake additional substantial adjustment within a very short timeframe. This is necessary to stabilize the balance of payments, reduce the fiscal deficit, and contain inflation so as to preserve confidence in the peso. To its credit, the De la Madrid administration has taken several steps to contain the fiscal deficit. These include the following:

The continued divestiture of state enterprises, including the closing of a large, but inefficient, steel mill involving the loss of 5,000 jobs;

Reduction in direct subsidies to parastatals, a problem that has plagued Mexico now for many years;

Reduction in government subsidies for basic goods and services;

Encouraging increased foreign investment and a reduction of the debt burden through the use of debt/equity swaps; and

Finally, implementing a tight credit policy which in the first four months of 1986 reversed capital flows into Mexico.

The Mexican authorities estimate that in 1986 they will lose about $6 billion in oil export earnings. They also estimate that total external financial requirements are on the order of $5 to $6 billion. This is not much greater than the amount estimated before the drop in oil prices.

The reason for this is that the Mexicans themselves expect to absorb the bulk of the loss in oil revenues. In fact, economic activity in 1986 is anticipated to decline by 3 to 5 percent.

As I have noted, large public sector deficits are a major source of inflation in Mexico. Like most other developing countries, Mexico has limited domestic private savings and underdeveloped capital markets. As a result, Mexico is often forced to monetize as much as half of its fiscal deficit. Foreign borrowing can be used to help finance the deficit, but it may not always be available in sufficient quantity.

Thus, Mexico has not been able to avoid some of the most undesirable effects of deficit financing, as indicated by the rise in recent months of inflation. At present, inflation is running at about 85 percent on an annual basis, compared to 64 percent in 1985, and 28 percent in 1981.

Foreign investment capital could play a more significant role in Mexico's development at a time when additional bank lending is both difficult and unattractive. However, the foreign investment law adopted in 1973 and subsequent government decrees affecting autos, pharmaceuticals, and other sectors, have adversely affected Mexico's investment climate.

The De la Madrid administration announced this past March that it would administer the foreign investment law more flexibly. The increase in the number of applications approved since then seems to indicate a change in attitude. The decision last year to allow a major U.S. multinational to set up a 100-percent wholly owned subsidiary in Mexico was another indication of a more open attitude toward foreign direct investment by the De la Madrid administration.

The De la Madrid administration is also trying innovative approaches to attract foreign direct investment. Recently, it has been promoting debt/equity swaps, which have the benefit of reducing the foreign debt while potentially increasing equity capital flows.

Mexico agreed to a provision in its 1985 debt rescheduling agreement with commercial banks to allow for the use of debt/equity swaps. We believe, and the Mexicans agree, that debt/equity swaps can play an expanding role not only in direct investment by foreigners, but also in the possible reflow of capital held abroad by Mexican nationals.

Mexico is also making considerable progress in rationalizing its trading system through replacement of most import licenses with tariffs. This eliminates unnecessary redtape and represents a first step in opening up the Mexican economy to foreign competition. To help this process along, Mexico is negotiating a large trade liberalization loan with the World Bank.

Mexico is one of the major debtor countries expected to benefit from the Program for Sustained Growth. It is presently involved in intensive negotiations with the World Bank on a number of fast-disbursing policy-based loans, including the trade liberalization loan already mentioned.

These loans are expected to increase World Bank lending to Mexico in 1986 to about $1 billion net, which is significantly higher than the previous level.

In addition, the Mexican authorities are engaged in continuing negotiations with the IMF on a new standby arrangement. Not surprisingly, we understand that the size of the fiscal deficit and the accompanying inflation rate are major issues under discussion.

We hope that the two sides can soon come to an agreement so that Mexico can begin negotiations with the commercial banks on a new money package. If Mexico can successfully implement a new IMF program and important economic reforms in connection with this program and with its World Bank loan, there is every reason to believe that private credit markets will respond.

Mr. Chairman, I have briefly reviewed Mexico's economic situation. I have attempted to be candid in my comments in the hope that by airing these issues fully, we can better appreciate Mexico's economic problems.

Mexico is an important trade and investment partner. We have been working closely with the Mexican authorities and they have kept us fully informed of their situation. In our experience, Mexico's economic team has demonstrated competence and a strong commitment to improve their country's economic performance.

The development of the Mexican economy is in the interest of both Mexico and its creditors. Patience, objectivity and sound judgment are of the utmost importance at this juncture.

The task ahead is not easy. But with our support, Mexico's own efforts to grapple with its difficult economic problems, and with the assistance of the international financial institutions and private banks, we are confident that Mexico can stabilize its situation and return to sustainable economic growth.

I thank you very much, Mr. Chairman.

Senator Helms. Mr. Secretary, I thank you.

I take it that you do not find much agreement with what Senator Gramm said just immediately prior to your testimony.

On page 4 of your statement, you mention the continued divestiture of State enterprises, and then you say including the closing of a large but inefficient steel mill involving the loss of 5,000 jobs.

What are the other divestitures that come to your mind?

Mr. Mulford. At one time, the peak number of companies that the Mexican Government owned was approximately 1,200 or 1,250, and I believe that number now has been worked down to about 850. I cannot give you off the top of my head a list of all those companies, but I would be happy to supply something to you for the record on that.

Senator Helms. Very well.

[The information referred to follows:]

Reponse of David C. Mulford to Question Asked by Senator Helms

Question. Which parastatals has the Mexican government sold, or closed?

Answer. To our knowledge, the Government of Mexico has sold the parastatals listed below. The Steel Mill Fundidora Monterrey, the oldest in Latin America (founded in 1900), and the associated firm Planos de Aceros were closed at a cost of 10,000 jobs. All the companies listed below were sold in 1985. We have yet to receive an update on parastatals sold by the Mexican Government this year.

Company:	*Government percentage*
1. Manufacturas Cargo	100.00
2. Refrescos y Alimentos Garci-Crespo	100.00
3. Embotelladora Garci-Crespo	100.00
4. Transportes Garci-Crespo	100.00
5. Granja Buenagua	100.00
6. Inmobiliavia La Cantera	100.00
7. Villas El Presidente Garza Blanca	100.00
8. Focolare	100.00
9. 21 of 53 condominiums in Fideicomiso Kin-Ha	100.00
10. Manatiales de San Lorenzo	80.00
11. Hotel Aristos Ixtapa	74.50
12. Distribuidora San Lorenzo	60.00

13. Manufacturera Mexicana de Partes de Automoviles	53.35
14. Nacional Hotelera	50.00
15. Minera Comonfort	45.00
16. Centrifugas Broadbent Interamericana	40.00
17. Hotel Aristos Cancun	38.80
18. Bolsas de Papel Guadalajara	37.50
19. Bolsas y Articulos de Papel	33.00
20. Compania Mexicana de Radiologia CGR	29.00
21. Grupo Condumex	16.00
22. Amercoat Mexicana	7.70
23. Bicicletas Condor	N.A.

Senator HELMS. On page 5, you mentioned the decision last year to allow a major U.S. multinational set up a 100 percent wholly owned subsidiary. What was that multinational?

Mr. MULFORD. The multinational there was IBM.

Senator HELMS. By the way, let's proceed on a 10-minute timeframe.

There are high level meetings to which I have already alluded going on today in Mexico and in Washington. What can you tell us about these meetings, including who is involved in them, on our side, anyhow.

Mr. MULFORD. I really cannot comment on that, Mr. Chairman. So far as I know, there are not high level meetings going on in Mexico City today between ourselves and the Mexican Government and I know of no meetings going on today here between ourselves and the Mexican Government.

Senator HELMS. All right. How about yesterday or tomorrow?

Mr. MULFORD. I don't know of any meetings.

Senator HELMS. There are no meetings that you know about?

Mr. MULFORD. I know of no meetings going on at this time and I know of no plans in the next day or so to have meetings.

Senator HELMS. Is our government suggesting to Mexico that Mexico abandon some of its unproductive ecnomic institutions, such as nationalized agriculture, nationalized banking, that sort of thing, in connection with whatever we plan to do with respect to helping Mexico?

Mr. MULFORD. Mr. Chairman, we have had and continue to have close relations with the Mexican financial authorities and throughout my experience in conversations with them we have always suggested that the reforms necessary in Mexico to make their economy have an opportunity, in our view for stronger positive growth, do have to do with a reduction in general in the role of the government in the economy. So the issues that you have mentioned have certainly been discussed again and again, and in considerable detail.

The Mexicans themselves have indicated that they intend to take steps in that direction and, in fact, they have already taken steps in that direction. So, I think one could say that there is an understanding of what the nature of the problem is there and the direction to be moved.

The issue is the pace of movement and the size of adjustment that has to be accomplished.

Senator HELMS. I have just been handed a story from the Wall Street Journal of this morning saying that high level discussions between United States and Mexican officials began yesterday in

Washington and Mexico City. It mentions the Mexican Finance Minister, who is going to meet soon—whatever that means—with Jim Baker and Secretary Shultz and Mr. Volcker, et cetera.

You don't know anything about that?

Mr. MULFORD. Well, Mr. Chairman, we have had many meetings with the Mexicans. We have been in close touch with them over the months and we are in close touch with them today. But I cannot speculate here on specific meetings that are referred to in the Wall Street Journal this morning.

Senator HELMS. Let me say this, Mr. Secretary. I am not your adversary, nor am I an adversary of Mexico.

Now this has been portrayed through the media. I notice that one of the hostile newspapers quoted me as saying that all Latins are hostile, or volatile, some word like that.

But there is a pronounced effort, I think, among the media of this country to overlook the corruption and drug trafficking and all of that stuff that appeared on the record in previous hearings.

Now I notice you did not mention one word about that. Are you taking the position that that does not have any effect on the economic circumstances there and here, and on the attitudes in both countries?

Mr. MULFORD. I am sure that that issue has an effect on attitudes in both countries, especially in recent times, as played in the press. But in my particular concern, Mr. Chairman, I am dealing with the financial authorities in Mexico with whom we have had long and constructive relationships. They have always displayed an open mind. They have been in friendly conversations with us constantly over the last 4 or 5 years about their difficulties. Where it has been appropriate, we have given advice.

But, as you know, the decisions that need to be made in Mexico are Mexican decisions. They are, at the moment, engaged in very delicate discussions with the International Monetary Fund, attempting to come to an understanding with the Fund. They are also in negotiations with the World Bank.

Ultimately, they will have further discussions with the commercial banks.

We have found that the Mexicans have demonstrated a constructive attitude toward their problems. As I mentioned in my testimony, they have not allowed interest arrears to grow at any time. That is something that cannot be said for other countries. They have met their obligations, and they have always indicated to us the intention to meet their obligations and to carry out reforms in their economy.

Senator HELMS. Let's go back to August 1982, to which you alluded in your statement.

What specifically did the United States do to help Mexico at that time?

Mr. MULFORD. Well, first of all, we had general discussions with them about economic policies, as we are now, so that there was a general consultation about their economic problems. But there was also a substantial amount of assistance given at that time, which you yourself mentioned this morning and which I would like to run down and give detail on here, if you would permit me.

Senator **Helms**. I hope you include a statement that the United States agreed to buy oil from Mexico in advance for the Strategic Petroleum Reserve. That is correct, isn't it?

Mr. **Mulford**. Well, the total package amounted to $9.45 billion at that time, of which $3.9 billion was an IMF arrangement with Mexico. There was a swap from the Federal Reserve of $700 million, which was a short-term swap. There was a swap arranged by the Bank for International Settlements in Switzerland, which was an internationally supported swap, in which the Exchange Stabilization Fund of the Treasury participated to the extent of $600 million and the Fed participated to the extent of $325 million, thus making up a total, with the assistance of other countries, of $1.85 billion.

There were advance oil purchases of $1 billion.

Senator **Helms**. At above market prices, I might add.

Mr. **Mulford**. I myself do not have a record of the prices that were executed.

Senator **Helms**. Well, I do.

Mr. **Mulford**. But it was a $1 billion advance purchase.

There were CCC credits given at that time of about $1.7 billion, and Exim credits given of about $300 million.

Now, of those credits, the IMF arrangement, the Fed swap, the Bank for International Settlement swap, all of those were short term in nature—that is, under 1 year—and were paid off in full. The oil arrangement was completely fulfilled; that is to say, the oil was delivered, as agreed, so that was resolved.

The CCC credits and the Exim credits, of course, were longer term credits. They were not short-term credits, and they were in the normal course of the business of both those agencies. They have not been repaid, therefore, because they are long-term credits; or, if they did come through for payment, they have been rescheduled with other official credits.

But I think that one can agree that, of that package, the Mexicans have honored all aspects of it, repaid it, and there was no cost there to the U.S. taxpayer.

Senator **Helms**. Senator Mathias.

Senator **Mathias**. Mr. Secretary, on page 5 of your statement you talk about debt/equity swaps.

Dr. Arthur Burns, who has always been one of my mentors in this field, wrote a couple of years ago that we ought to be as creative in dealing with international economic problems as we are with domestic banking problems. In his career as a banker, he said that he had seen many innovative, creative ways of dealing with personal debt, individual debt, and that we ought to be just as innovative and creative in dealing with international debt.

Do you think this debt/equity swap falls in that category?

Mr. **Mulford**. As you know, I am, by profession, an international investment banker, in which career I spent some 20 years before coming to Washington.

I believe that debt/equity swaps offer a tremendously valuable instrument and a very creative instrument for contributing to the ultimate resolution of the debt problem, not only in Mexico, but in other debtor countries as well.

Senator MATHIAS. Well, I am not an international banker. So could you tell us exactly how it works.

Mr. MULFORD. Well, there are different kinds of debt/equity swaps, but I think there are two general types that I could summarize.

One is where banks holding the fixed income obligations of a debtor country would negotiate a conversion of that debt into an equity position in a financial institution in the debtor country, and they would do so with the consent and participation of the central bank of the debtor country, which would allow for the conversion of the debt into equity on very favorable terms.

This, of course, requires that the host country, in this case, would welcome such an investment by foreign financial institutions in their domestic financial institutions. That is not always possible, but it has been done recently in a couple of cases, most notably in Chile.

The other type of debt/equity swap would be where a bank that holds the debt instrument of a debtor country sells it out of its portfolio to either a multinational company or to a private investor, which could be a foreigner, or it could be a national of the country, the debtor country. The buyer then takes that paper, which it has bought from the bank at a discount, goes to the central bank of the debtor country, and converts it on favorable terms for the purpose of investing in equity.

This has the benefit of reducing the outstanding stock of debt of the debtor country. It also has the benefit of reducing the exposure of those banks to that country, and it increases the flow of equity to the country.

So, in a sense, everybody can come out a winner.

It is particularly important, in my view, to develop this technique, say, in the case of Mexico, where it has already agreed in an agreement with the banks, which was reached in 1983-84. There is a provision which allows for debt/equity swaps if Mexican nationals could be allowed to buy this paper from foreign banks with the capital that they have sent out of Mexico, and they can buy that at a discount, return it to Mexico for the purpose, say, of investing in parastatal shares that are offered when the Government privatizes companies. You could see here a vehicle for a substantial reflow of capital by the nationals of that country into their own domestic market again.

This is why I believe it has such tremendous potential.

Senator MATHIAS. What about the elimination of trading import licenses?

Mr. MULFORD. That has been beneficial. It covers, as I remember, about 40 percent of products in Mexico. It has the benefit of removing the redtape applied up with applying for licenses, and although the tariff has the effect of impacting the price at which that product comes into the market, at least that product comes in at a price and competes with local industry. That should be beneficial for developing greater competitiveness in Mexican industry vis-a-vis the world. Therefore, we view that as a positive step on their part and a courageous step.

Senator MATHIAS. One of the functions of the Treasury Department is to have some overview of drug traffic, is it not?

Mr. Mulford. Yes; that is correct.

Senator Mathias. Do you have any worldwide figures on sources of drugs imported into the United States?

Mr. Mulford. I don't have such figures, Senator, because it is not an area with which I have any real connection and have no responsibility for, but I am sure we can provide those to you.

Senator Mathias. Will you provide those figures, then, for the record? I think that would be useful to get some idea of comparative sources of this problem.

[The information referred to follows:]

Response of David C. Mulford to Question Asked by Senator Mathias

Question. Do you have any worldwide figures on sources of drugs imported in the United States?

Answer. We have data on U.S. Customs seizures of negotiable money instruments in the Southeast Border Region (Laredo, El Paso, Nogales, San Diego). These funds were either not reported to Customs, as required by law, or were in violation of the Racketeering Act. While we have no way of confirming that all of these funds are related to drug trafficking, we can safely assume that some of them are. In fiscal year 1985, 207 seizures of funds took place for a total amount of $16.5 million, up from 194 seizures in fiscal year 1984 amounting to $13.8 million.

Senator Mathias. I think we need to be very careful about where we point the finger here. I am speaking from ignorance here as I do not myself know where it comes from.

I don't know what my friend, Jesse, said about the Latins, but I am an Anglo, and I am a little volatile.

Senator Helms. So am I.

Senator Mathias. I think we have to be accurate on this subject, so, wherever the chips fall, let them fall. I think we need to know.

Senator Helms. If the Senator would yield, I wish he had heard the testimony at our previous hearing about drug trafficking.

Senator Mathias. Well, I regret very much that I was not here.

Senator Helms. We cannot be everywhere at the same time, I understand that.

Senator Mathias. I had hoped that we might schedule that at a mutually convenient time, but I know that was not possible.

Thank you, Mr. Chairman.

Senator Helms. Thank you.

Senator Dodd.

Senator Dodd Thank you, Mr. Chairman. Let me, if I may, try to pick up on the last comment before I get into my questions.

Mr. Mulford, I, too, agree with the assessment of Senator Mathias. I think that we have a tendency to focus on the problems that exist between Mexico and the United States. But what is remarkable is not that there are so many problems, but, rather, how good the relationship has been. There are only three cases in the world that I am aware of where you have an industrialized nation that shares a border with a Third World nation—Israel, South Africa, and the United States.

In the case of South Africa and Israel, the relationship between their Third World neighbors and themselves is a highly hostile one, with terrible relations. Ours are remarkably good between these two countries.

It always seems that we are very quick to criticize Mexico and very cautious to praise it when it does do things such as the Secretary has identified here this morning. My thought is that the idea of having hearings and discussing these issues is certainly a worthwhile one. I do not like the idea that we cannot talk about certain subjects, as some would suggest. But I think we ought to be very, very careful.

I can only begin to imagine what the reaction would be like in this country if the Director of the Customs Department of Mexico stood before a congressional hearing in Mexico and identified the Governor of Texas or the Governor of Arizona or the Governor of New Mexico as a drug trafficker, only to find out within hours that the information was inaccurate and that apologies had to be made. There would be a furor in this country if something like that had occurred, or if the Mexicans decided to have a hearing——

Senator HELMS. If you would yield, Mr. von Raab did not say that.

Senator DODD. Let me just finish, if I can—or if they decided to have a hearing in Mexico on the *Deaver* case. How would we react to that kind of situation.

I just think we have to be a little more cautious, careful, and balanced.

I appreciate the testimony of the Assistant Secretary. I think it is a balanced approach. It identifies some problems and things we have to explore together. Obviously what happens to this economy of our neighbor has a profound and immediate effect on ourselves. If we do not engage in this discussion in that kind of environment, then I think we run the risk of seeing further deterioration and further consolidation, and not for sound reasons, but for the kind of position we put people in politically in their own countries.

Let me, if I can, get to a couple of basic economic questions, Secretary Mulford.

What is your view of the total external financing requirements which Mexico will need this year in order to cover its existing external obligations? Do you have a ballpark figure on that?

Mr. MULFORD. Yes.

We have estimated really, since the beginning of 1986, that Mexico's needs, her external financing needs, will fall in the range of $5 to $6 billion for 1986. This is a figure which the Mexicans are in basic agreement with.

As you know, the problem is in the domestic financing side.

Senator DODD. I understand that as well.

And, as you point out, they have taken significant steps over the last 3 or 4 years, at great sacrifice to their own people, to impose rather stringent belt-tightening requirements on their country.

Senator MATHIAS. Senator Dodd, would you yield for a quick question?

Senator DODD. Certainly.

Senator MATHIAS. What is the time schedule on the need for this $5 billion in 1986?

Mr. MULFORD. Well, this is a ballpark figure for the year. Of course, as the year passes, Mexico is meeting its obligations and has reduced its reserves somewhat to do this. Eventually it will need an amount of approximately this size to cover its external financing requirement.

Senator MATHIAS. My question is really to determine whether we are going to face some kind of crunch here later in the year.

Mr. MULFORD. No, I don't think so, because Mexico's pattern of debt service payments is fairly steady and even throughout the year. I think it is about $750 million per month.

So, obviously, as you move toward the end of the year, it gets to be a much more important problem; but it is not a problem that will be coming upon us in one fell swoop.

Senator MATHIAS. I thank the Senator for yielding.

Senator DODD. You are talking about the ballooning effect, the delaying of some of these things earlier on. But you don't see that?

Where are the source of assistance to cover its ballooning external obligation? How much is IMF, how much is commercial banks, how much bilateral assistance, if anything, are we anticipating in the way of trying to assist in the meeting of that external obligation?

Mr. MULFORD. There are various sources that are used traditionally to finance such an external requirement. But, in general, in Mexico's case, the sources are of the type that have been used in the past, as ordinarily have been available.

There would be if they finish the negotiation an IMF program, and I think the amount there is something like $1 billion. They are negotiating something in the neighborhood of $1 billion in World Bank loans. They anticipate, I believe, a new financing package, net new money from the banks of something in the neighborhood of $2.5 to $2.7 billion. There is availability of funds to them in theory if they should negotiate a Paris Club rescheduling. That amount—it is hard to be exactly specific—probably falls between $600 and $900 million.

Senator DODD. You are getting pretty close.

Mr. MULFORD. They also have been in negotiations recently with Japan, though I do not have the exact numbers there, for export credit financing arrangements connected with certain projects, and they have an estimated number there.

The point I am making is that traditional sources of finance which have been used in the past to finance external requirements for Mexico are still the same type of sources that are there today.

Senator DODD. Could you identify for us to the extent possible how much the dramatic drop in oil prices has had an effect on the Mexican Government's ability to meet its external debt obligations? What impact has that had?

We often hear of Mexico's failure to have a more aggressive market-oriented economy. But I am wondering if you could identify how much this particular problem of the dramatic drop in oil prices has exacerbated the Mexican problems of dealing with this debt problem.

Mr. MULFORD. It is hard, of course, to be absolutely precise, Senator. But, in general, they have lost approximately $6 billion of oil revenue by virtue of the price decline.

As I said in my testimony, this translates into a 25-percent reduction in their Government revenue.

Now, if you translate that into any country's budget, you can imagine a very severe problem, especially if it happens in the short space of 6 weeks and has to be adjusted for within a very short period thereafter.

So, the magnitude of adjustment, domestically, for Mexico is very, very substantial.

But, to come back to your question, Mexico, as I said, will have a reduction of something like $6 billion in its revenues from the sale of oil and, therefore, in its foreign exchange earnings.

Senator DODD. That is on a yearly basis, annualized?

Mr. MULFORD. This is in 1986. But there are certain advantages to Mexico in the world today that offset that loss. I would just like to mention those generally.

One is, as you know, there has been a decline in interest rates that has been very substantial, and that will flow through to Mexico and save them something like $1.3 or $1.4 billion. They have had certain negotiations going on with the banks about how they price their loans, and they have had an advantage there recently given to them by the banks to convert pricing from one type to another. That will save them something like $700 million this year.

There are savings flowing back to them this year by virtue of negotiations with the banks over past spreads that are going to result in a flowback of $400-some million to them. There is the increase in growth in developed countries around the world that is the product of reduced oil prices, and this means that there will be a better chance for an increase in Mexican exports than otherwise would have been. That might earn another $300 or $400 million. And so on.

When you finish the day, the net result for Mexico is a decline of about $2.5 to $3.5 billion. That is about how we would assess that shift.

Senator DODD. That is a good picture.

You point out some positive things, such as lower interest rates, and so forth. But, as a general proposition, the situation that Mexico finds itself in today, despite the efforts which you have accurately identified in your statement, the crunch, if you will, would be far less drastic in the absence of this dramatic decline in oil prices than what it is with it.

Mr. MULFORD. Oh, yes.

I think it is fair to say that Mexico was adjusting quite well until it ran into some problems in 1985, as I outlined in my testimony, and those, then, were substantially increased by the sharp decline in oil revenues in early 1986, for which they were not prepared, of course, nor was anybody. They have now had to face the logic of that development, which is very substantial domestic budget adjustment in a short period of time.

We all know from our experience how difficult this is politically and economically for any country.

Senator DODD. Let me just—oh, my time is up.

Senator HELMS. Go ahead, Senator.

Senator DODD. Thank you.

How would you characterize them, Mexico's ongoing negotiations with commercial banks?

Second, do you perceive any risk at all that, if those negotiations were to collapse for whatever reason, we might find Mexico going the route of, say, Peru, which I gather has unilaterally decided that it will determine its own debt rescheduling repayments?

Is there any danger of that that you can see?

Mr. **MULFORD**. Let me answer your question by going back a bit in time and just saying that, in general, Mexico's relationship with its banking group has been positive and constructive, as compared with all the other debtor countries. Mexico has been a leader, I would say.

They have negotiated very fine terms with the banks. They were the first country to do a multiyear rescheduling with the banks of their outstanding debt, and I think that total amounted to something like $49 billion of rescheduled debt on a multiyear basis.

So they have had good relations.

However, in recent times, there has been a growing concern among the banks that reform in Mexico, domestic reform, has not been sufficiently intensive and that they have not accomplished the degree of domestic economic reform that is regarded as desirable, and, therefore, the banks have expressed some reluctance to put up additional new money unless they see further credible reforms on a broad range of fronts, including foreign direct investment and domestic policies opening markets, monetary policies, exchange rate policies, and so on, and the banks have expressed this reluctance from time to time.

Then, when the oil price drop took place and the degree of the problem increased substantially, the banks, of course, became concerned, and it has been more difficult for Mexico to complete the negotiations necessary for an IMF standby program.

They are still negotiating at this time, and if they were able to complete these negotiations, which we believe is a possibility, certainly a very good possibility, then I have no doubt that as the IMF Program comes into force and the World Bank negotiations are completed, the commercial banks would step up and commit additional new funds. The likelihood is that the program Mexico comes up with that satisfies these requirements will also be a program that convinces the banks that it is time to put net new money into Mexico to begin the adjustment process anew.

Senator **DODD**. I may come back with some additional questions, but let me thank you for excellent, excellent testimony.

Thank you very much.

Mr. **MULFORD**. Thank you very much, indeed, sir.

Senator **DODD**. Thank you, Mr. Chairman.

Senator **HELMS**. Thank you, Senator Dodd.

Senator Evans.

Senator **EVANS**. Thank you, Mr. Chairman.

Just as a preface, you mention on page 2 of your testimony that real interest rates in the late 1970's were negative. Thus, as is the case with other large debtors, Mexico's continued borrowing from abroad was not surprising.

When you get into a circumstance of negative real interest rates, imprudent action is not confined to the actions of nations, is it? Would you judge that much of the rampant speculation in farmland and the collapse in farm prices in this country may have started with that kind of circumstance internally within our own nation?

Mr. MULFORD. Well, I think it is a fair proposition in general to say that when money is easy, inflation is high and interest rates are negative, there tends to be rather heavy borrowing by countries, private people, companies, et cetera, and that when economic circumstances change and inflation is reduced and gradually wrung out of the system and interest rates go positive, there is a very tough adjustment for everybody.

We have seen it in this country in a variety of sectors, and it is not surprising that in the debtor countries we have seen the same type of thing going on since 1981.

Senator EVANS. So we should not expect really that the actions of Mexico during that period of time were any different than actions of other individuals, other nations, other people around the world. It is the kind of thing that happens, given that combination of circumstances, isn't it?

Mr. MULFORD. I think that is right.

I think it is fair to say that Mexico, confronted before 1981 with negative interest rates, took the view that it would like to continue growth, to borrow more money, and finance their growth for the time being through that period. That proved to be the wrong decision for Mexico, but also for a lot of other people as well.

Senator EVANS. In a recent article in "The Economist," they suggested four potential policies, economic policies, of the Mexican Government that might help during this period of crisis. Some of them have been mentioned already in the testimony and discussion this morning.

Foreign investment, of course, is one. Land tenure is another, although they suggested that the rural way of life is so deeply rooted in their system that tampering with it may be politically out of the question.

Let me focus on the other two, especially privatization.

You mentioned the debt/equity swaps. Those are primarily aimed at financial institutions. But I thought I heard you say that also there was the potential for such swaps in parastatal investments.

Do you see a real potential there for debt/equity swaps that would lead to at least partial privatization of some of the Government-owned industries in Mexico and partial private ownership of non-Mexican investors?

Mr. MULFORD. Well, as I said, I see this as a very positive instrument. I think the Mexican Government sees it that way, too.

I do not think debt/equity swaps are primarily going to be used just for financial institutions. I think the real possibility lies in both industrial development, or industrial investment, and also where private citizens or national companies of a debtor country that have money outside, that is, capital flight money, decide that because the right measures are being taken in the country to stabilize the situation and the Government is selling off parastatal enterprises, this is the time to bring money back into the country in order to buy those shares.

I would like to give you an example.

If you had moved your money out of Mexico some years ago, when the exchange rate was 12 or 25 pesos to the dollar, and you held dollars today, and you believed that the adjustment was now going to be credible and there was going to be a return of growth, you might decide that it was very attractive to use your dollars to buy Mexican debt at, let us just say, 60 or 65 cents on the dollar, from a bank, take that down, cash it in at par for pesos that are used to buy attractive equities being sold by the Government.

So that is a very, very attractive financial proposition, and that could have a lot to do with reflowing money. It is just a question of getting the basics right in the economy so that the right atmosphere is there, and then letting this tool be used on a relatively sound basis to provide some reflow of money.

I think this holds real promise.

Senator MATHIAS. Senator Evans, would you yield for a minute.

Senator EVANS. Certainly.

Senator MATHIAS. What is the current level of private external debt in Mexico?

Mr. MULFORD. Private external debt?

Senator MATHIAS. Yes; we usually think in terms of the public debt. But there is a substantial private external debt as well.

Mr. MULFORD. I am told that it is $17.5 billion.

Senator MATHIAS. Billion?

Mr. MULFORD. Billion dollars.

But I am referring here not to the private debt. I am referring to the flow of money out of Mexico, where Mexican citizens have private assets outside Mexico that, in due course, will be attractive for them to bring back home.

Senator MATHIAS. I understand that.

But it raised the question in my mind of what the level of private external debt was, which is substantial.

Mr. MULFORD. Yes, $17.5 billion.

Senator MATHIAS. Thank you for yielding.

Senator EVANS. You mentioned that in order to get this to work, everything would have to be in line and there would have to be some confidence among those who held money outside of Mexico that there was going to be stability. But it would also require a significant decision by the Mexican Government to engage perhaps more enthusiastically than now in divestiture of state owned enterprises.

Do you see that as a real possibility?

Mr. MULFORD. Well, it requires two things. One, it requires an enthusiastic divestiture, that is correct. The Government has said to us that they plan to sell something like 200 parastatal companies. Of course, not all of those are in such good condition.

Senator EVANS. I was just going to ask about that. Would the likelihood be that they would sell the 200 least attractive?

Mr. MULFORD. I think they would have to face the prospects of selling some attractive ones and some unattractive ones and perhaps closing some companies, as they did with the steel company.

The point is that where an attractive company is sold, there, I think, the Mexican Government has already agreed in principle to allow debt/equity swaps because it already has that provision in its arrangement with the banks. It is already negotiated and in place. And, in fact, there have already been debt/equity swaps done.

I would cite a couple of cases. There were two transactions recently done by Japanese companies using the debt/equity swap technique for $60 million and $20 million. Nissan Motors and Komatsu both used this technique to expand investment in Mexico. An American chemical company, Rohm & Haas, also used it to buy a company in Mexico.

Of course, you need an open investment policy that encourages the flow of foreign investment on the part of the Mexican Government to make this happen as well.

Senator EVANS. Let me turn to the fourth area that was suggested, and that was free trade. The suggestion in the article was that Mexico blocks imports through tariffs and quotas in a thicket of bureaucratic regulations. You mentioned on page 3 of your statement that Mexico's imports dropped by two-thirds between 1981 and 1983, a development that contributed to our own growing trade deficit. Are we in a circumstance here where, by trying to correct some of the problems in Mexico, we may be creating additional problems for ourselves? Certainly, by encouraging a drop in imports by Mexico in order to stabilize their own financial situation, they are presumably helping to exacerbate our own trade imbalance.

I guess that is one of the immediate things that happens, is it not?

Mr. MULFORD. Yes.

That question is interesting, because our trade with Mexico had declined in the early years because of the deep recession that Mexico entered, and therefore they did not import so much from us. Our trade balance with Mexico, for example, which in 1980 was plus $2.3 billion and in 1981 was $3.6 billion positive turned negative in 1982 by $4.4 billion, by $7.8 billion negative in 1983, by $6 billion negative in 1984, and by $5 billion negative in 1985.

So, clearly, Mexico's health is of great interest to us as an economy. If they can restore their growth, which, after all, is the key aim here of an adjustment program in Mexico, they will, of course, increase their capacity to once again trade with us and take more of our product.

Therefore, we have a great interest in seeing Mexico's health restored from an economic standpoint, not to mention all the other reasons that we have.

Senator EVANS. Would you care to estimate how much of that change in the early 1980's occurred because of deliberate decisions by the Mexican Government to limit imports because of their own financial stringencies, and how much may have occurred because of the strengthening of the American dollar and the effect it had elsewhere in the world, at least, on our trading abilities?

Mr. MULFORD. I think that would be an extremely difficult calculation, which would be beyond my competence here at this desk. We could have a shot at it and try to give it to you, but that would be very difficult.

[The information referred to follows:]

RESPONSE OF DAVID C. MULFORD TO QUESTION ASKED BY SENATOR EVANS

Question. What effect do Mexican import controls and the overvalued dollar have on the U.S. trade deficit with Mexico?

Answer. The overvalued dollar is not a significant factor in the U.S. trade deficit with Mexico because usually it is the peso which is over-valued vis-a-vis the dollar, not the other way around. The U.S. Dept. of Commerce has a trade model for Mexico which indicates that the combined effect of the level of economic activity (real GDP) and Mexico's debt burden is more than twice as large as the effect of the exchange rate on Mexico's imports.

Senator EVANS. Well, were we both involved or was it primarily the decisions of the Government to restrict imports?

Mr. MULFORD. Well, I wouldn't say it was the decision of the Government in Mexico to restrict imports so much as just the cutback in economic activity reduced imports into that market. The Mexicans have restrictive trade practices. They are highly protective and we hope that they make changes on those policies.

But, given the size of their market at that time, when their economy declined, the effect on us and on our trade deficit was dramatic.

This is a pattern not only true in Mexico, but all over Latin America, where economies contracted and our trade turned negative with them.

Senator EVANS. Mr. Chairman, if I might use a little time of the colleague from Maryland——

Senator HELMS. Go right ahead.

Senator MATHIAS. That's fine.

Senator EVANS [continuing]. I have one final question.

In your view, is it an important thing for them to reduce those tariff and other trade barriers and to engage in a freer trading system in terms of their long-term economic health?

Mr. MULFORD. Yes; it is very important because Mexico needs to make its economy more internationally competitive. That really is the heart of that issue.

Therefore, the faster that they can liberalize their trade arrangements, the better off they are going to be in the long run.

But, obviously, in the short run, there are special-interest groups that are politically powerful in Mexico and business groups that are not receptive to increasing competitiveness because they have a situation at the moment which, for them, happens to be attractive for the time being.

So there is resistance to this from certain quarters in Mexico, understandable, and it is a difficult political problem.

But, in general, the moves the Government can make to open their economy and liberalize their trade regime will help restore long-term growth on a lower inflation basis in Mexico.

Senator EVANS. That sounds like a sound policy for other nations, including our own, doesn't it?

Mr. MULFORD. When I said that Mexico has not always been able to do everything that was desirable, I certainly had in mind that there are certain things in this country that we would also like to do, such as reducing the deficit, which has turned out to be more difficult than we had anticipated.

Senator EVANS. And reducing trade barriers as well?

Mr. MULFORD. And reducing trade barriers.

Senator EVANS. I thank the chairman.

Senator HELMS. The Chair would observe that it is our intent to finish the list of witnesses. Inasmuch as the Senate will go out at 12 for 2 hours, we will be within the Senate rules. So we will continue until we finish our final panel.

I have a couple of loose ends and then I will recognize the distinguished Senator from Alaska.

This Senator—and I am speaking for nobody but myself—would be delighted for the Customs Director of Mexico to identify anybody in this country involved in drug trafficking based on the evidence that was submitted to this committee, which I think was both relevant and accurate.

Second, all witnesses for each of the hearings have been approved by both sides. So there has been no selective designation of witnesses.

You talked about imports by Mexico from the United States. Isn't it also true that Mexico has not been able to meet its quota of exports to the United States in such things as steel, textiles, and others? Isn't that correct?

Mr. **MULFORD**. Do you mean because our market has not been open to them or do you mean that they have not been able to produce the goods?

Senator **HELMS**. They just didn't have the production to do it.

Mr. **MULFORD**. Well, it is certainly true that the Mexican economy—and this is not unusual either for oil producing countries—when oil became such a tremendously valuable commodity to them, with a rising price over a period of years, Mexico did not diversify its economy as fully as it might have for the purpose of exports in other areas. Therefore, it has a rather narrowly based economy, too dependent on oil export revenues.

So, when the crunch came, they were hit very hard by it and could not move as quickly into other export areas as they perhaps would have liked to have done.

That is a function of the structural problems in Mexico and it is that sort of thing which the right policies over time would change.

Senator **HELMS**. But the answer to my question is yes.

Mr. **MULFORD**. Yes.

Senator **HELMS**. Senator Murkowski.

Senator **MATHIAS**. I have just a quick cleanup question, if you would yield, Senator.

Senator **MURKOWSKI**. Sure, go ahead.

Senator **MATHIAS**. You mentioned the fall-off in exports from the United States to Mexico.

Can you give us a ballpark figure on the number of jobs that cost the United States?

Mr. **MULFORD**. I am afraid that I cannot do that off the top of my head, but I would be happy to supply that to you.

Senator **MATHIAS**. Thank you. We would appreciate receiving it.

[The information referred to follows:]

RESPONSE OF DAVID C. MULFORD TO QUESTION ASKED BY SENATOR MATHIAS

Question. How does a reduction in U.S. exports affect U.S. employment?

Answer. The U.S. Dept. of Commerce estimates that every $1 billion reduction in U.S. exports cost 25,800 jobs in 1984.

Senator **MATHIAS**. Just one other thing.

Mr. **MULFORD**. That is always a difficult exercise, of course, Senator, that calculation.

Senator **MATHIAS**. It is difficult, and that is why I say a ballpark figure, because it depends on so many variables.

You just issued an invitation to the Director of Customs of Mexico to identify American drug traffickers. It would be difficult for him to accept that invitation under the committee rules because we allow only United States citizens——

Senator **Helms**. No, no. I did not issue an invitation. I used precisely the parameters that the Senator from Connecticut did. He said if the Customs Director of Mexico should appear before the legislature in Mexico.

Senator **Mathias**. Well, my point is this.

Senator **Helms**. Whatever, suits me.

Senator **Mathias**. My point is that we don't need him. We have United States Attorneys in every Federal judicial district in this country who are organized to deal with drug traffic in this country and we can ask them, and they can give us a pretty good idea of the nature of the drug traffic here.

Senator **Dodd**. If I might interpose, my point was simply that we had a situation where we had to have the administration, in a very public way, issue apologies to Mexican officials because of the inaccurate statements of a witness before this committee.

My point was that if there were hearings in Mexico where you had the Customs Director of that country inaccurately identify a Governor of one of our border States as being involved in drug trafficing, there would be a furor in this country over that kind of irresponsible behavior.

My point was that, while I think these hearings can be helpful, I think to engage in sort of "bashing," which becomes popular, does not contribute to the serious problems that face our two countries. That was my only point.

Senator **Helms**. Well, to my knowledge, the administration has not apologized for any statement as having been inaccurate being incorrect in any characterization about it.

They simply did not look at the record of what Mr. von Raab said.

Again, I must defend the Customs Director because his information was correct and it was based on sound information.

Senator Murkowski.

Senator **Murkowski**. Thank you, Mr. Chairman.

I was in attendance at that particular hearing. I think the very fact that we got out on the table the significance of the drug problem in the border area but the realization that there is a tremendous increase in drug trafficking coming out of Mexico, is sufficient to show that steps have to be taken.

My questions this morning are going to be very brief, Mr. Chairman.

I would like to ask the witness, Mr. Mulford, whether he anticipates that U.S. banks may be looking at some $7 billion worth of interest, I gather, that is going to be due later this month. If the interest is not paid, the banks are going to have to make a decision to call for a default. My question is: What is the likelihood of the banks rewriting the interest, bringing the loans current, and proceding under whatever repayment program might be agreed upon between the banks and the Government of Mexico?

Mr. **Mulford**. I don't know. The figure you used seems to me to be high.

Senator **Murkowski**. Well, it may be high. But whatever the figure is, there is a call at the end of the month, is there not, of Mexican credits?

Mr. **Mulford**. No. There is a $2.7 billion make on the flow of payments from Mexico to servie its debt. One is that they are fairly evenly spaced through the year, and they amount to something like $750 million a month. There is not a single, large overhanging payment that needs to be made, to my knowledge.

Second, Mexico at the present time has adequate reserves and resources to meet its debt servicing requirements for the time being.

The problem arises if it does not succeed in putting into place a program renegotiating its financial arrangements over a period of time, and so on.

The near-term problem for Mexico is manageable.

Senator **Murkowski**. Well, it is my understanding that there is approximately $100 billion in foreign debt.

Mr. **Mulford**. Yes.

Senator **Murkowski**. That is supported by a number of articles. Some of that debt is past due or will be at the end of this month, and the interest payment is questionable at this time.

Now, are you suggesting, sir, that Mexico will be able to meet that interest requirement at the end of the month? The figure I have is $7 billion. But be that as it may, there is a considerable demand on Mexico for fulfillment of a debt obligation at the end of the month.

Is that not correct?

Mr. **Mulford**. I don't think there is any magic about the end of this particular month in the case of Mexico. I can go back and review the numbers.

Senator **Murkowski**. Well, regardless of whether or not it is the end of the month, are they going to be able to make the interest payment?

Mr. **Mulford**. Well, they have interest payments of about $750 million a month, of which about $250 million is owed to U.S. banks. They have about $78 billion of debt to banks, of which about $24 billion is owed to U.S. banks.

So, about 30 percent of their bank debt is with U.S. banks, about 33 percent.

As I said, Mexico has adequate reserves at the moment and foreign exchange earnings to meet these payments. But obviously, as we have said earlier, here, it needs to make arrangements to finance its external requirements over time, and it is, at the present, engaged in negotiations with the IMF and others to make those arrangements.

Senator **Murkowski**. From your answer, then, I assume you anticipated that they will be able to meet those debt obligations as they come due from their reserves. That is encouraging, to say the least.

I am curious to know about a reference made in the testimony this morning, Mr. Chairman, with regard to the merits of trading debt for equity; in other words, some kind of exchange. I am wondering whether we have also looked at the merits of trying to accommodate Mexico by utilizing more of what they most produce, and that is oil?

Is there not a possibility that we could increase oil purchases from Mexico, and is there not a current surplus of Mexican crude available if we were to encourage private purchasers to purchase more?

Mr. MULFORD. As I have said before, we have had a continuous discussion with the Mexicans over recent months about their problems, and we have not excluded any area for discussion.

Senator MURKOWSKI. Have we specifically mentioned oil?

Mr. MULFORD. Oil has been discussed, and we have discussed a wide variety of other areas.

Senator MURKOWSKI. I would be interested in knowing specifically if there was any followup on oil.

Mr. MULFORD. There was no followup agreed to, nothing, no understanding reached.

We have not excluded any possibilities as we have talked with them and we will not do so in the future.

Senator MURKOWSKI. Is there anything that is going to bear fruit in the immediate future that looks more promising than this to assist their economy? By purchasing more of something that would be in our best interest, we could reduce transportation charges and assist them in their accumulation of dollars.

Mr. MULFORD. Well, I don't think we need to do that at this stage because, as I have said before, if they complete their negotiations with the Fund and with the World Bank and then undertake their discussions with the commercial banks, and they use the other resources that are available to them for external financing, there should be adequate resources available to meet their needs without turning to any unusual types of transactions at this time.

Senator MURKOWSKI. Well, your testimony is certainly reassuring in comparison to what I have been reading in the various newspapers on the coming financial crisis in Mexico.

Let me ask you this. Is there any request from American banks or financial institutions for guarantees, government guarantees, on standing credits to Mexico at this time?

Mr. MULFORD. No, there have been no such requests.

Senator MURKOWSKI. I have no further questions, Mr. Chairman. Thank you.

Senator DODD. Mr. Chairman, I have just a couple of brief questions, if I could, just to followup.

Senator HELMS. All right.

Senator DODD. Senator Evans raised the question as did Senator Mathias about the private external debt capital flight issue.

Obviously we have benefitted to some degree because of capital flight. Foreign capital in this country many argue is one of the things that has saved us over the last several years from the kind of credit crunch that might have resulted as a result of our tremendously high deficits.

I say that in terms of thinking about this issue in balance.

Capital flight is a major problem, I think, not only just in Mexico but around the Third World.

Are there any steps being contemplated by the Mexican Government to handle the capital flight issue or at least to reduce the size of it?

Have they asked us in any way to participate in such a program?

Mr. MULFORD. Well, there have not, per se, asked us to participate in any program aimed specifically at that issue from the standpoint of trying to get us in some way to resist the flow or to return money, something of that kind.

Instead, there has been a discussion of the roots of the problem, which have to do with such things as the investment climate in Mexico, the fact that not at all times have there been positive interest rates in Mexico, or a realistic exchange rate policy, and these things have contributed from time to time in their experience and in the experience of other countries to capital flight.

But I would point out, as I think I mentioned in my testimony this morning, that this year, in recent months, Mexico has been running a very tight monetary policy with high positive real interest rates, and the effect of that policy up until now, in recent times, has been a reflow of funds into Mexico.

So, their reserves actually increased in the first 3 or 4 months of the year. Therefore, the capital flight problem has not been a continuous problem. It is a problem that comes and goes, depending upon the outlook and degree of confidence at any one time.

Senator DODD. Last, there was Senator Evans question about the trade issue.

Mexico is presently negotiating to participate in the upcoming GATT negotiations. I would suppose you would see that as a very positive sign because for many years, Mexico has not sought to be a participant at all in the GATT.

I am wondering how those negotiations are proceeding. I am not familiar myself with how you even negotiate to be a member of GATT. Do we take a public position with regard to Mexico's request in all of this, or a private position in support of that request?

Mr. MULFORD. I am not current on the latest state of those negotiations, but we have taken a positive position on Mexico's decision because we believe, and have always believed, that it is very important and also in Mexico's interest to be a member of GATT. We are very pleased to see them seeking membership.

This is one of the decisions that we would point to for which we think Mexico should get some credit—to undertake a negotiation to join GATT that will have some effect in liberalizing their own trade regime. This has to be a positive economic step and we support it.

Senator DODD. So I am accurate, and this is the first time that Mexico has requested to be a participant?

Mr. MULFORD. No; they made an earlier request. They indicated an intention to join GATT at an earlier time, though I cannot remember the exact date, but they did not then complete the process.

Senator DODD. So this is the first time they have really pursued it this far.

Mr. MULFORD. This is the first time there has been pursuit of this magnitude.

Senator MURKOWSKI. Mr. Chairman, I wonder if I would make just one observation.

Senator DODD. I would be glad to yield to my colleague from Alaska.

Senator MURKOWSKI. I apologize and I appreciate my friend from Connecticut yielding.

Mr. Mulford, is it not correct that the interest due at the end of July 1 will be $1.8 billion?

Mr. MULFORD. On July 1?

Senator MURKOWSKI. Yes.

Mr. MULFORD. That is not a figure I am familiar with as interest being due on July 1. But I could be wrong.

Senator MURKOWSKI. Well, it comes from the Wall Street Journal article of June 10 entitled, "U.S. is Urging Mexico to Meet Debt Schedule." The article is written by Art Pine. I would be happy to provide it to you.

It says that Mexico's options would include refusing to pay $1.8 billion in interest due July 1.

Mr. MULFORD. Well, I did check that figure before coming up here. It was a fairly quick check, but I am certain that the figure is not correct. Sometimes those things appear incorrectly in the press.

Senator MURKOWSKI. I understand that.

On the question of capital outflow, I assume the figure that you are using is $50 to $60 billion.

Mr. MULFORD. Well, that is a very difficult figure to calculate.

Senator MURKOWSKI. What would you calculate and use, through, from the standpoint of your own analysis?

Mr. MULFORD. Well, I think figures of that magnitude have been calculated by financial organizations, such as the BIS, for example.

We have not attempted to put an exact figure on it. But we have been interested in what I would call the magnitude of highly liquid offshore assets owned by Mexicans, as opposed to money that has left and gone into real estate and so on.

Senator MURKOWSKI. Similar to the type of assets Marcos moved out of the Philippines?

Mr. MULFORD. Well, no.

The reason we are interested in the liquid assets is because they do serve the basis for debt/equity swaps, and therefore that is an important number to try to get a feel for because that number could theoretically be reversed back by investors quite quickly.

Senator MURKOWSKI. What is the figure that you use?

Mr. MULFORD. Well, we don't know exactly what that is.

Senator MURKOWSKI. Well, what do you feel comfortable with?

Mr. MULFORD. I feel comfortable perhaps with a figure of something like $10 to $12 billion.

Senator MURKOWSKI. So it is substantially less than the $50 or $60 billion that is being kicked around——

Mr. MULFORD. Oh, yes.

Senator MURKOWSKI [continuing]. Because you are looking at liquid assets.

Well, it would seem to me, Mr. Chairman, that any time you have this kind of an outflow of capital, you have a lack of confidence in government, and it is very, very difficult to turn that around. Next to the wife and kids, money is right up there, and if they think they are going to lose it in one country, they will move it out. We have seen an outstanding example recently in the situation in the Philippines, and it is clear that what it shows is a lack of confidence by investors.

The only way you can turn it around is for the internal reform necessary within Mexico to be initiated.

Mr. MULFORD. Yes.

Senator MURKOWSKI. And that has yet to happen.

I would certainly hope, Mr. Chairman, that as a consequence of your hearings, steps will be taken to help establish the confidence necessary to cause those with substantial funds available to reinvest in Mexico, because that is what is needed.

Thank you very much.

Senator MATHIAS. If the Senator would yield——

Senator MURKOWSKI. Yes.

Senator MATHIAS. I would make the same caveat that I made before. It is not always lack of confidence in the government.

There is no lack of confidence in the German Government, and there is no lack of confidence in the French Government and other European governments, but there is substantial flight of capital from those countries.

Senator DODD. What about Japan?

Senator MATHIAS. Yes, Japan.

Senator DODD. There is hardly a lack of confidence in Japan.

Senator MATHIAS. I think, to understand what is happening here, we have to keep that point in mind.

Senator MURKOWSKI. If my colleague would yield, I think we also have to keep in mind what we saw very recently in the Philippines, which was certainly a lack of confidence.

Senator MATHIAS. That is only a factor.

Senator MURKOWSKI. So, while I do not wish to dispute my colleague, you can have a lack of confidence on one hand and you can have a higher return on investment elsewhere. Both will cause an outflow of capital.

One thing about money is that it is like water, it finds it own level—and very fast.

Senator MATHIAS. And its opportunities for advancement.

Senator MURKOWSKI. The highest return and the least risk. That is where money goes.

Senator HELMS. Well, having conducted a referendum on confidence in governments around the world, we thank you very much, Mr. Secretary.

Mr. MULFORD. Thank you very much for having me, sir.

Senator HELMS. Now we will proceed to our third panel, consisting of Dr. Paul Craig Roberts, of Georgetown University's Center for Strategic and International Studies.

Excuse me, but in the interest of time, we would ask our departing guest to move along as rapidly as possible. We hate to lose you, but we have some further business to conduct. I would say in the meantime that it is the Chair's intent to plow ahead and finish our third panel.

I repeat, our third and concluding panel will consist of Dr. Paul Craig Roberts, whom I have already identified, Grady E. Means of Coopers & Lybrand, Richard Feinberg of the Overseas Development Council, and Bruce R. Magid of the Bank of America.

In the order you were listed, I recognize Mr. Roberts.

But first, let me say at the outset that I anticipate your patience. I did not expect that the other panels would run quite as long as they did, but it has been quite informative and we have had quite a good dialog.

So, Dr. Roberts, you are recognized.

STATEMENT OF PAUL CRAIG ROBERTS, WILLIAM E. SIMON CHAIR IN POLITICAL ECONOMY, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY

Mr. ROBERTS. Thank you, Mr. Chairman. I will be very brief.

Mr. Chairman and members of the committee, I have been keeping an eye on Mexico since 1981 when the Federal Reserve unexpectedly plunged the world into recession and collapsed the prices of commodities that were the basis for debt service and loan repayment by Third World countries.

Overnight, the great achievement, as it was called, of petrodollar recycling through financial intermediaries, such as U.S. banks, was turned into a very big problem. The Federal Reserve and indeed the entire Government was slow to recognize the massive problem that had been created by the Federal Reserve's serious departure from administration policy.

It was not until the summer of 1982, when Mr. Volcker received a telephone call from Mexico, that he realized that he had collapsed the asset values underlying the world debt structure, thus creating a serious financial crisis.

Banks have lent large sums to Third World governments based on projections of higher oil, copper, and other prices. The inflationary decade of the 1970's had taught the banks that inflation was a way of life and that growing export earnings from oil revenues would make it easy for Mexico to handle its debts.

When the U.S. inflation rate collapsed suddenly and unexpectedly by 9 to 10 percentage points between 1980 and 1982, the banks began to realize that the price projections on which they had based the loans would not materialize, and that they had seriously overexposed their capital.

Between 1982 and 1984, U.S. banks stopped lending, and U.S. capital outflows dropped from $119 billion in 1982 to $20 billion in 1984.

This extraordinary decline in the supply of dollars in foreign exchange markets pushed the price of the exchange value, of the dollar sharply higher, which further increased the burden of the loans on the debtor countries.

The collapse in U.S. capital outflows was also the source of the large U.S. trade deficit, which increased protectionist pressures and raised further doubts about the ability of debtor countries to service their debts by selling us their products.

The crisis was avoided by lending money to pay interest, which increased the debt burdens of the debtors and passed the sinking ship on to the future.

At the time, former Treasury Secretary William E. Simon, and former chairman of the Chase Manhattan Bank, George Champion, and I and a few others expressed skepticism of the approach taken, but the Congress and the public were assured that incrased funding for the IMF was the solution.

The lack of foresight to deal realistically with the problem has turned an economic problem into a diplomatic and foreign policy problem. Basically, the loans are being politicized and the politicization of the debt crisis is interweaving the future of free banking in the United States and the prestige of our foreign policy with the fate of a one-party State whose image is suffering.

It is clear that piling debt upon debt has only worsened the problem. The loans cannot be bailed out; they can only be bailed out from under.

This means that someone has to bite the bullet.

Mexico could do it by selling off nationalized firms and by accepting private foreign investment. The U.S. banks could help by writing off the worst of the loans. A good solution would be to wrap both approaches into one package that would reduce Mexico's external debt to a manageable level.

If the politicization of the debt continues, we will end up with a captive U.S. foreign policy.

Mr. Chairman, the most promising way to deal with the current crisis is to cut a deal on the debt that diverts control of resources from government to private hands. This means cutting the debt down and not building it; it means privatizing the Mexican economy by converting debt to equity. No one needs to be left out of the bullet biting.

If something realistic is done, Mexico has a good chance. If something political is again done, the sinking ship is simply passed on. There is one thing about sinking ships: eventually they sink.

With the communists solidifying their hold in Nicaragua, the sinking of the Mexican ship of state has a lot of implications for the United States.

Adding to the debt is bound to increase the politicization of the debt. Last week, the Mexican President again reiterated his charges that foreign creditors are choking the nation to death.

It is not implausible that the Mexicans will respond to their problems by adopting a more extreme political rhetoric, countering the image of economic failure and political corruption.

In the end, they may simply set themselves up for the Communists.

The quicker the debt is curtailed by writeoffs and conversions to equity, the less likely Mexico is to sink. I think the principle that should guide all of this is to reduce the vulnerability, both of the debtor countries and of their creditor institutions.

Thank you, Mr. Chairman. That summarizes my statement.

[The prepared statement of Mr. Roberts appears in the appendix.]

Senator HELMS. Thank you, Mr. Roberts.

Mr. Means.

STATEMENT OF GRADY E. MEANS, DIRECTOR, INTERNATIONAL BUSINESS ANALYSIS, COOPERS AND LYBRAND

Mr. MEANS. Mr. Chairman, members of the committee, I appreciate the opportunity to be able to address the committee on the subject of the current Mexican economy and the potential problems that may arise over the next couple of years.

I am Grady Means, and I manage the International Business Analysis Group of Coopers and Lybrand, which is one of the big eight accounting and consulting firms.

The group performs analysis of over 100 countries worldwide and assists our U.S. corporate clients in defining their overseas investment objectives and planning overseas ventures.

The group draws upon our firm's 515 overseas offices for information on local economies.

For the most part, my comments are going to be drawn from a report which we just released, which is entitled, "The 1986 Annual Report on the Worldwide Economic and Business Climate," which I think has been made avialable to the members of the committee.

The report reviews countries and regions worldwide and attempts to provide an objective assessment of current economic and business prospects for nearly 100 countries.

In reading the report, I think you will find that Mexico plays a key role in our assessment. The declining price of oil and the huge foreign debt has put tremendous pressure on the Mexican economy, which could lead to severe crisis.

In 1986, Mexico might be considered the one developing economy whose economic problems could have the greatest impact on the United States from an economic and a political perspective.

I have a longer statement available to the committee and the economic report is also available, which I submit for the record with your permission.

Senator HELMS. Yes.

[Please note: The 1986 Annual Report on the Worldwide Economic and Business Climate may be directly obtained from Coopers and Lybrand, 1800 M Street NW., Washington, DC 20036.]

Mr. MEANS. Thank you.

Let me summarize the key issues as they relate to Mexico.

Commodity-based economies, like Mexico, are finding their primary exports selling at low prices and can expect that condition to continue for at least a decade.

To be successful and to generate sufficient foreign exchange, such economies must convert rapidly to economies that produce high quality value added manufactured exports, competitive by world standards.

Mexico faces daunting problems in moving in this direction.

Oil revenues, which may some day come to be regarded as a curse for Mexico, may have tended to mask their serious structural problems in manufacturing and prevented them from making the commodity-to-manufacturing transition that Brazil successfully achieved. This may leave a tragic legacy.

While Brazil and perhaps Argentina are stabilizing their economic and debt problems, Mexico's can only get worse. While Brazil and Argentina have lowered their inflation rates from several hundred percent to nearly zero, Mexico has no hope of that in the near term, with increased peso devaluation and subsequent impoverishment likely.

While Brazil and perhaps Argentina should experience steady growth and market expansion over the next decade, Mexico will probably face low economic growth or, more likely, decline.

In short, compared to her Latin American friends, Mexico cannot share in the world's economic recoveries and may face increasingly severe crises.

Pulling many of these concepts together, our economic report creates a competitive vulnerability index for countries which compares their value added manufacturing capacity with their dependence on commodity exports, and ranks the major economies of the world.

Mexico scores very poorly.

From this perspective, Mexico ranks with Venezuela, Indonesia, and Chile, as one of the most vulnerable countries in the world.

On the other hand, countries like Argentina, Brazil, and India, as well as the rapidly industrializing countries of the Pacific Rim, are considerably less vulnerable and thus expected to sustain a reasonable growth rate over the next decade.

But Mexico's fate is certainly not sealed. The country has many strengths which it could take advantage of. With all of its reliance on commodities, Mexico is still the 10th largest manufacturing country in the noncommunist world. As data in the report indicate, manufacturing output for Mexico exceeds that of such countries as Australia, Korea, Taiwan, South Africa, Argentina, Hong Kong or Singapore—all highly regarded countries.

With renewed capital investment, Mexico could increase its manufacturing output further and become perhaps the eighth largest manufacturing economy in the Free World.

It is also useful to recognize that Mexico's growth has not been purely debt financed. Between 1974 and 1984, 85 percent of Mexico's investment capital came from internal sources. There was a very strong rate of internal capital formation.

The normal formula for change in such economies involves reattracting capital investment back into Mexico and developing value added manufacturing economic bases.

From the experience of many developing countries attempting to achieve these goals, the usual recipe, as we have heard today, involves privatization, lessened protectionism, cutting deficits, a broadening of democratic and free market institutions, exchange of debt for equity, and related policies which restore investor confidence and utilize market forces to achieve truly competitive manufacturing sectors.

Mexico does not score well currently on any of these factors either, and, as noted in the report, ranks relatively low from the point of view of movement toward privatization and lower protectionist barriers.

Because of that, Mexican manufactured goods are considered by most corporations to be relatively low quality and noncompetitive by world standards.

In grappling with these issues, the Mexican Government is not unaware or unsophisticated.

In that context, it is useful to note that, although the normal formula for economic development is a useful guide, it is often politically difficult to institute and, at times, very ineffective.

Many countries have ignored some of these basic principles and still established highly competitive economies tailored to their local social and economic conditions.

Japan has maintained many formal and informal protectionist barriers and, nonetheless, has become one of the most vibrant and fast-growing economies in the world.

Brazil, from 1962 to 1984, was not a democracy, but a state-run economy, centrally directed, and yet achieved one of the most dramatic transitions from a commodity based economy to a manufacturing economy of any developing nation in the world.

In short, it is necessary to tailor programs to realities within the countries and Mexico's realities are very unique.

The factors that are absolutely necessary for a successful transition from a commodity based economy to a modern manufacturing economy are the political will to undertake such a program and the political economy conditions to effectively execute it.

In short, more important than what Mexico actually does is that Mexico do something significant and soon in order to develop a value added manufacturing sector and competitive exports.

Mexico is clearly searching very seriously for an effective formula in these areas, and U.S. policy can support such a search.

Thank you Mr. Chairman.

[The prepared statement of Mr. Means appears in the appendix.]

Senator **Helms**. Thank you very much, Mr. Means.

Mr. Feinberg.

STATEMENT OF RICHARD E. FEINBERG, VICE PRESIDENT, OVERSEAS DEVELOPMENT COUNCIL

Mr. **Feinberg**. Mr. Chairman, I am delighted to have this opportunity to testify today on a matter of great importance to American foreign policy. Thanks in part to the work of your committee, American attention today is riveted on Mexico.

I personally am deeply worried about the state of United States-Mexican relations and about U.S. relations with much of the developing world.

Mexico is now serving as the lightening rod for the multiple frustrations that many Americans feel toward the Third World more generally. Many Americans believe that we have poured billions of dollars of aid into developing countries to no avail.

On the contrary, the Third World seems to be typified in the public eye by what I will call the five C's—corruption, cocaine, capital flight, communism, and chaotic violence.

The most prominent images of the Third World broadcast recently into American living rooms include Qaddafi's threatening fist, Imelda Marcos' 2,000 pairs of shoes, Daniel Ortega's defiant smirk, and bales of confiscated marijuana.

The U.S. media now are full of stories regarding Mexican corruption, drug dealing, lawlessness, and capital flight. These stories make for exciting reading and contain kernels of truth.

Yet you and I, Mr. Chairman, know that these images are misleading guides to the complexities of developing countries.

If the American people come to see them as the essential truth, it will be impossible for the U.S. Government to conduct a sensible and nuanced foreign policy. Policy makers will become prisoners of the popular imagination.

The Mexican system is indeed deeply flawed, as is our own. But what I want to do in the next few minutes is to paint a picture of a nation that has suffered tremendously in the last 4 years and that, notwithstanding mistakes and hesitations, is making major efforts to overcome past errors and to make itself into a more modern society.

Yet, as Senator Dodd said, rather than receive recognition for its efforts, Mexico has faced escalating criticisms. Now, as a result, Mexico too is frustrated. Two nations seething with mutual frustrations cannot be good neighbors.

As Senator Mathias said and Mr. Mulford emphasized, the Mexican economy has been subject to a relentless series of severe shocks in the international economy from private capital markets, high interest rates, and now from the oil market. Mexican policy makers were slow to respond, but eventually had no choice but to adjust by sharply slashing their merchandise imports.

This correction was accomplished by a series of fierce devaluations, as your charts suggest, and by painful cuts in living standards.

Industrial workers in Mexico today earn some 30 to 40 percent less than they did in 1980, and public expenditures by the Government have been shaved by some 25 percent.

Consider, Senator, what it would mean to strip American workers of one-third of their income and cut U.S. fiscal spending by one-quarter.

Mexico made these sacrifices while continuing to service its foreign debt. Over the last 4 years, Mexico has devoted nearly $40 billion and roughly 40 percent of its export earnings to meeting its international financial obligations. This outflow has absorbed about 6 percent of GNP.

If the United States were paying out 6 percent of its GNP, that would equal $240 billion each year. To place the sum in perspective, $240 billion is over two-thirds of our spending on national defense and surpasses by half our entire trade deficit.

Since Mexico's debt payments have exceeded capital inflows by a wide margin, Mexico has been transfering resources to the United States and other creditor nations. Mexico, in fact, has been aiding the U.S. economy.

Expectations of rewards and fear that hostile behavior would incite severe sanctions explain Mexico's exemplary behavior.

Mexico hoped that prudent financial management would reopen its access to private markets and it also feared that aggressive tactics would provoke retaliation, the curtailing of trade credits, and possibly the seizure of overseas assets.

Consequently, the Mexican Government considered it riskier to deprive American banks of their interest payments than to cut the wages of Mexican workers.

But the rewards promised for good behavior have, for the most part, failed to materialize.

The commercial banks have become increasingly critical of Mexico and of Latin America in general. The banks' strategic objective seems to be to reduce their hemispheric exposure relative to their overall assets and their capital. So long as the banks' overriding objective is to lend as little as possible to Latin America, no amount of good behavior or economic reform in Latin America is likely to call forth substantial amounts of new loans.

With the potential carrots withering, Mexican compliance has become a function of fear. But economic relationships held together primarily by distrust are inherently unstable.

As Assistant Secretary Mulford emphasized, this year's oil price fall has destabilized Mexico's balance of payments and fiscal policy. Consequently, the peso is now under severe pressure, despite very high domestic interest rates in Mexico, and inflation may be moving up to 100 percent.

Per capita income levels may drop again by 5 to 7 percent this year in Mexico.

Mexico initially anticipated borrowing $4 to $5 billion in 1986. When the oil price suddenly collapsed, Mexico sought an additional $4-$5 billion to see its way through this latest shock. But creditors turned a deaf ear.

Humiliated, the Mexican Government announced that maybe it did not need the extra $4 billion after all.

The current impasse arises in large measure because the Mexican perception of the crisis is so different from ours. Many Mexicans are critical of their Government's performance, but they also blame U.S. fiscal and monetary policies for high interest rates, which Mr. Mathias emphasized. They look at the commercial banks and fault them for leaping from very enthusiastic overlending in the 1970's and early 1980's to now frigid underlending.

The Mexican Government laments that the creditors fail to appreciate some of the reforms it has begun in order to lay a foundation for long-term growth. In a major reversal of its traditional nationalism, Mexico is now negotiating entry into the GATT and is working closely with the World Bank to reduce and rationalize its trade barriers. Relations governing foreign investment have also been liberalized.

Some in the Mexican Government are arguing that their good behavior on debt has merely led the banks to believe that they could continue to throw the burden of future adjustments onto Mexico. The banks' refusal to provide much fresh money in response to the oil price shock fuels this belief.

Other Mexicans fear that those in the United States who have long opposed the nationalism and statism of the PRI now see their opportunity and will settle for nothing less than rolling back the Mexican Revolution.

In Mexico City, the influence of voices pressing for a harder line against the United States is rising. As you are well aware, many Americans see a different picture. But they do correctly note Mexico's backsliding on its fiscal performance in 1985, perceive a lack of firm leadership following the recent oil price crash, and believe the trade and investment reforms do not go far enough.

Some Americans even doubt that the announced reforms will be seriously implemented. In short, the administration of de la Madrid is suffering a credibility gap in the United States.

Critics of Mexico are pointing to capital flight as a sign that Mexicans themselves have lost faith in their system. The commercial banks ask "Why should we make loans that will soon find their way back to Houston and Miami?"

Certainly, Mexican capital flight has reached damaging levels. But I would argue that some degree of capital outflow is both normal and even beneficial.

As Senator Mathias suggested, when American corporations or individual investors place their money in foreign currencies, it is called "portfolio diversification." Does the privilege of hedging against uncertainties belong only to residents of industrial countries?

I have calculated that, according to one measure, capital flight out of Canada over the last several years has been at least as large as capital flight out of Mexico.

Moreover, Mexican capital flight has benefited some U.S. interests, as Senator Dodd noted earlier. Capital inflows have helped cover our balance of payments and fiscal deficits. And the very same banks that decry capital flight are willing takers, are even active seekers, of foreign deposits.

Both Mexico and the United States should take measures to reduce capital outflow from Mexico. But its persistence is neither abnormal nor immoral, and it is not in our interest to halt it entirely.

The deterioration in the Mexican economy and polity and in U.S.-Mexican relations threatens both nations' vital interests, as Senator Gramm so correctly pointed out. Both nations need to rethink current policies.

The Mexican political system is not on the verge of collapse, but the grip of traditional institutions is clearly weakening. The poor are alienated, the middle class is demoralized, and the Government is widely viewed in Mexico as indecisive, colorless and distant.

Our own behavior is inadvertently weakening segments of Mexican public opinion favorably disposed to the United States. Those Mexicans who advocate economic liberalization lose strength when Mexico is continually slapped by the international economic system. The perceived absence of rewards for good behavior tilts the debate toward those who advocate unilateral action.

When we further heap public scorn on Mexican officials, we generate a negative, nationalist reaction among many sectors of Mexican society. I think we can see the testimony of Secretary Mulford today as an attempt at damage control in Mexico City.

The Mexican financial crisis threatens to undermine U.S. global debt strategy. The Baker initiative may be mortally wounded unless the IMF and the World Bank reach accords with Mexico, accords which are consistent with the initiative's emphasis on renewed growth.

The dangers to both nations are great and growing, and rising bilateral tensions could hinder cooperation on a wide range of issues, including drugs, immigration and border problems. But this is also a moment to turn crisis into opportunity.

By way of conclusion, Mr. Chairman, let me suggest that the Mexican economy needs a new deal. The Mexican Government must come up with a package of bold measures that address short-term financial problems as well as structural obstacles to growth.

Such a plan can only succeed with the financial and moral backing of the United States and the international financial community. It is for the Mexicans to propose their own program. There are no easy recipes—no Betty Crocker cookbooks for economic development. [Senator Helms smiled.]

But clearly Mexico needs reforms in the area of foreign exchange management and in the area of tax policy. The Mexican Government should sit down with its private sector leaders and World Bank officials and, building on innovative programs already underway, these parties should work out basic, visible reforms in trade, investment, and public sector enterprises.

Mexico also needs a new deal from its creditors. Mexico cannot afford to continue to transfer such a large percentage of its foreign exchange earnings and domestic savings abroad if it is to resume investment and create jobs.

Increased official flows are part of the answer. But the gap must be narrowed between the interest bill being paid to commercial banks and the amount of new money that they are willing to extend.

To support Mexico's reform program, the U.S. Government and the international lending agencies should lead the commercial banks into doing their part.

Mexico's reform program will require a strong endorsement by the entire U.S. Government in order to restore confidence in the Mexican currency and economy. Such a package deal could renew confidence in U.S.-Mexican relations and transform a deepening distrust into a renewed partnership. It could also be a major triumph for American foreign policy.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Feinberg appears in the appendix.]

Senator HELMS. Thank you, Mr. Feinberg.

Mr. Magid, you are next, and would you please pull the microphone up a bit closer.

STATEMENT OF BRUCE R. MAGID, VICE PRESIDENT AND CHIEF INTERNATIONAL ECONOMIST, LATIN AMERICAN DIVISION, BANK OF AMERICA

Mr. MAGID. Thank you, Mr. Chairman.

In the interest of brevity, and in the interest of keeping this hearing going along, I will just make a few brief comments.

First, I would like to apologize on behalf of Executive Vice President William Young of Bank of America, who is in charge of the Latin American Division and head of the Global Refinancing Group, who had originally planned to attend this session and who would be more than happy to attend in the future. He asked me, however, in my capacity as Chief International Economist for Latin America to convey a few key points to this group regarding the bank's perspectives on Mexico and the process in general.

First, in the case of Mexico and all countries, one of the things that a commercial bank always looks for is to see the willingness of a country to undertake an adjustment program. We think in the case of Mexico that these may have been missed in the last few weeks by some of the press stories indicating that the Mexicans have been reluctant to move forward.

We can point to a number of articles. But, for instance, President De la Madrid gave a speech on February 21, 1986, where he acknowledged the necessity to readjust the economy through fundamental structural change.

Even before the latest movement in the price of oil, the Mexican Government officials had put together a program which, instead of projecting growth for 1986, was projecting recession.

In other words, we think the first thing is to look at the actions of the country itself: Does it have the willingness to undertake the reforms needed to deal with short-term problems and develop over the medium term?

Moving from the first point, we think it is very important in dealing with those short-term problems from the commercial bank perspective that the IMF, the International Monetary Fund, be involved in situations such as Mexico where new money will be requested from commercial banks. It is not the role of the commercial banks to be the final arbiters of the fine points of a program, and we look to see that the International Monetary Fund and institutions such as the World Bank will endose the program.

In the case of the IMF right now, it is our understanding that they are actively negotiating with the Mexican officials. We do not have the final details. We believe that negotiations are taking place. But, checking with individuals as of yesterday, it was our understanding that we expect an agreement to be reached with the IMF, a first step on coming to an agreement later with the commercial banks.

Of increasing importance over the past few years has been a third aspect that we look at, which is the process of structural adjustment, a medium term process—some people say 3 to 5 years, others say 7 to 10. But the point of the matter is that structural adjustment, i.e., allocating resources of an economy to where they can be most efficient and where they will be able to generate foreign exchange earnings, is a very important criteria.

The World Bank structural adjustment loan is a component of the Baker Plan, and we ourselves view Mexico entering into these types of loans as very important for its medium term viability and its capacity to meet its obligations.

We have touched on the major issues. But, just to once again bring up some of the major concerns, that would mean opening the economy up and an orientation toward export industries, allowing foreign investment, and making the state apparatus, particularly State corporations, more efficient and more manageable.

Here I would like to comment that I think we have already seen indications on the part of the Mexican Government, both through words and actions, that they are moving in the direction of structural adjustment.

The fourth point to mention is when we look at the issue of Mexico and its capacity to meet its debt payments, its ability to grow to meet the needs of its population, when we sit down into the financial engineering aspect of the proscess, that involves not just the Mexican Government, not just the IMF, but it involves at least five significant parties. Commercial banks are involved. The government itself is involved. Multilateral institutions, such as the IMF, the World Bank, and the Inter-American Development Bank are involved. Official agencies, be they from the United States, Japan, or other countries are involved. And finally, there are the direct investors themselves who are involved.

We expect all of those parties to continue to participate. In the same way that the banks will respond to the initiative of the IMF or the World Bank, the banks expect that their role is going to be a part of a general role and that the banks themselves are not looked upon as some appendage to the process.

Finally, I think we should mention that when you look at Mexico, it is important to point out that the real issue, in our view, confronting the Mexican Government is the need to get their hands around the fiscal deficit. The size of the fiscal deficit appears to be driven now by two factors. One is interest payments on existing debt. Here I should add that two-thirds of those payments are on domestic note obligations and not external note obligations. Second is the operation of State corporations.

Within this context, we applaud the Mexican Government's effort to begin to deal with the difficult process of dismantling some of these corporations and trying to make them more efficient.

Again, in sum, when you look at Mexico and what Mexico had accomplished prior to the drop in oil prices, many people had said that it was a miracle. Now we know that it was not a miracle, that there was still significant underlying structural problems.

However, to suddenly say that because the drop in oil prices has created a short-term liquidity crunch and that it is now unsolvable is again missing the point.

Mexico will most likely need a few years of assistance. It will need to implement structural adjustment. But by the concerted actions of the Mexican Government officials, the IMF, the World Bank and the commercial banks, from our institution's point of view, we expect Mexico to be in a position to both satisfy the growth and development aspirations of its people and to remain current on its obligations.

Thank you.

Senator Helms. Thank you very much for your eloquent statements.

Dr. Roberts, let's get to the bottom line.

Do you think Mexico will ever get out of this vicious circle of debt without changing its economic system into a more free enterprise mode?

Mr. Roberts. No, not unless there is a resurgence of inflation.

If you consider, for example, that the banks made many of those loans to Mexico based on projected oil prices of $65 a barrel, and that was as recently as 1980, I believe, when the price of oil was assumed to be at $65 a barrel by 1985 or 1986 and rising. Of course, if the price of oil was $65 a barrel, those Mexican loans would be good.

So, barring a return of the kind of inflation and inflationary expectations that we accumulated over the decade in the 1970s, barring that, then I think Mexico will have to make a lot of adjustments in its internal economy. And I do not think that the Mexicans are ultimately helped by adding to their external debt burden.

This, I think, was where we began to go wrong back in 1982. Then we were told that we just needed some time and money and that it would be all right. Well, it wasn't, and we are being told that again. All that happens is you pile debt upon debt upon debt, and you keep the process going of politicizing these debts.

You see, we are reaching the point where the private character of the U.S. banking system is imperiled.

If private commercial banks are encouraged by the Government to make loans to foreign Governments and something goes wrong with those loans, they could expect to have recourse to the United States Government. That will start involving the taxpayers, and then that starts involving all kinds of divisive political competition about why is it that we looked after the oilmen in Mexico and not in Oklahoma, and why did we look after the timber interests in Brazil and not those in Oregon, and so on.

In my own view, it is best not to accumulate those kinds of problems through time, because they tend to wear everybody out.

Senator **Helms**. Well, it was said several times here this morning by the Secretary, for example, something to the effect of being so quick to criticize Mexico. Well, I don't know of anybody who has been quick to criticize Mexico. That certainly is not the purpose of these hearings.

The purpose of these hearings is to have Congress get some idea of what its responsibility is to the people with respect to the bailout of the banks, and this has gone on and on and on with respect to various parts of the world.

Now I have no problem with the people of Mexico. They are good people. But I do have a problem with the policies and the responsibilities of the Congress.

I would like for you to comment on something. What do you think Congress should do to prepare the U.S. financial system in the event of a Mexican default, should it occur?

Is it inevitable that such a default would do serious damage to our own banking system?

Mr. **Roberts**. Well, if the banks waste time to set aside reserves, if the whole process of dealing with the loans gets into a track that you cannot get out of, of piling debt on debt on debt, and if that breaks down and the whole thing breaks down and the banks are not prepared, then yes, it would be quite a shock.

They have had several years, and in some instances at least they have built up their reserves against some of these loans, though nothing like I think they should have done.

I think the banks themselves are quite reluctant to lend more because they realize they have overexposed their capital, and they are less happy with the current scheme to have them lend more than they were in 1983, when they were quite pleased to be part of the IMF bailout or bail-in or support programs, or whatever you want to call it.

The banks are not so happy about it, because I think they feel that piling exposure upon exposure, when they do not see a clear resolution of the problem, has to concern them. I think it has to concern us, too.

This is why I say that I think the whole problem should be approached in a way that reduces the vulnerability of the banks and of the debtors.

Mexico has a lot of assets. If they were not intent on handling them in a certain way, those assets could help. If they did not want to be so upset about too much foreign investment, that would help.

But I do feel that if we continue to build that debt under the guise that we are buying a few more years for them to solve this problem, it is not going to work unless there is some sort of massive reflation in the United States.

Senator HELMS. Do you have any idea how much it would cost the Federal Government, that is to say the American taxpayers—we always talk about the Government this and the Government that; but the Government has nothing except what it takes from the people—how much it would cost the taxpayers of America to buy out the worthless portfolios of banks involved in this lending to Mexico? How much would it cost us if we do not and the debtor countries default? Do you have any figure in mind?

Mr. ROBERTS. Well, those are probably somewhat separate questions.

You would first have to decide which part of those loans are worthless. At this moment, I would not say that they all are.

Senator HELMS. I wouldn't either.

Mr. ROBERTS. And I would say that the probability of more of them being good would be increased if some of them were written off in order to reduce the burden.

I would say that had this been done several years ago, the loans would be better now than they are. I could not tell you what percentage of them is worthless. I think that would be something that the banks would have to negotiate with the Mexicans, and I think it is something that would be subject to negotiation.

I would not expect it to be particularly high unless the crisis continues and things drag on.

So, I think that probably the banks could stand some reasonable write-down of those loans better than they could stand the pressure cooker of going on, year by year, having their arms twisted by the Federal Reserve and everybody else to put more into this pot which they are already uneasy about, particularly if the Mexicans are not really going to change the way they do business, except for maybe a little bit here and there to keep this process going.

So I would say that the banks could probably afford some reasonable write-down of the loans.

Now, to buy them out totally, I would not propose that and would not think that too many people would. But there comes a time when you have to worry about the independence of U.S. foreign policy. If it gets all wrapped up with commercial banks that have been encouraged by the Government to lend to foreign governments, and it gets all wrapped up with keeping these foreign governments on an even keep, you just get more and more intertwined. And at some point you have basically lost control over the foreign policy. It is then controlled by this autonomous event.

Rather than have that happen, I would think it is something for the Congress to think about, whether they just would prefer to buy out the banks than to lose the independence of the foreign policy.

Senator HELMS. I think this has been the foreign policy in many respects.

I have one quick question for Mr. Means.

What is your view of the future of the manufacturing sector in Mexico?

Mr. **Means**. Under current conditions, the manufacturing sector in Mexico still has to be regarded as a highly protected sector. By world terms, it is not competitive. It is generally regarded as producing low quality manufactured goods.

The movement toward joining GATT is a positive sign. Certainly it may provide some discipline on the manufacturing sector in Mexico, although it may be a futile effort unless some major structural changes are made in Mexico, which are very difficult for Mexico to make.

When I look at Mexico, even as an economist, I do not see it as an economic problem. It is an institutional problem. It has one of the most complex institutional systems of any country I review, and I review about 100 countries.

I look at the miracles that have taken place economically recently in India, where it went from the basket case of the Club of Rome to being a net manufacturer and exporter of food, and at places like Brazil and Argentina, which have come back on the right track. Then I look at Mexico and try to figure out what kind of formula would really work there within the institutional apparatus of the PRI and its close alliance with the unions in Mexico. I must say I find it very difficult. I look at all of the formulae for privatization and for moving to the normal debt/equity swaps, and I really have trouble envisioning that working effectively in Mexico.

The problem with Mexico is that it is a much more subtle institutional environment. It is a major manufacturer. I said that in my statement. I have great hope that Mexico, in fact, may move toward value added manufacturing, just as many commodity based United States industries have, and have been very quick in doing so. There are certainly models that you can find in the United States economy for Mexico to recover and move toward value added manufacturing.

But I must say that the thing that makes me somewhat pessimistic is to try to figure out how that works through the institutional structure of the country, over which U.S. policy has almost no effect.

Senator **Helms**. Particularly where there are something like 800 or 1,000 government owned corporations in Mexico. Is that not correct?

Mr. **Means**. Mexico is a highly nationalized economy.

As far as their productive manufacturing, it is government directed.

Senator **Helms**. One final note and I will defer to Senator Mathias.

Much was said this morning about the 1982 assistance given to Mexico. That was shortly after Mexico nationalized the banks, wasn't it?

Mr. **Means**. Yes.

Senator **Helms**. So, what the United States did, with Congress not looking or understanding or caring was to put the imprimatur of Congress on the nationalization of the banks.

You know, this thing started way back there.

It is this sort of question, Mr. Means, that has led me to believe that there ought to be an exploration of the history of the situation. This is not to be critical of Mexico, but at least to put the flag down and say here is what we need to do and here are the assurances we need to have before we go further with this.

Senator Mathias.

Senator MATHIAS. I am amazed that we have gotten to this point in this hearing and no one has yet raised the question of the kind of strains on the Mexican economy which will occur as a result of population growth.

The conservative estimates of population growth are that Mexico will pass the 100 million mark sometime before the end of this century. Many Mexican politicians have views on population planning and birth control that are not too dissimilar from that of my friend, Senator Helms.

It is a touchy subject to raise politically in Mexico. But what is it going to mean? Let's leave the political and social aspects out. But what is it going to mean economically to Mexico? What is the cost of that kind of population growth?

Mr. FEINBERG. I might point out that the rapid population growth in Mexico over the past decades is now creating problems as even larger numbers of people are entering the job market. You now have something like 900,000 new entrants onto the job market every year. Of course, in the current recession, not only are those people not being given jobs, but people are being laid off.

However, the Mexican Government has quite successfully over the last decade directly tackled the population growth problem. And, according to official figures which I think are widely accepted, the population growth rate has declined from a high of about 3.5 percent down to about 2 percent, which is a reasonable growth rate, certainly for a developing country.

So one could also anticipate, and this is how it tends to work on a global basis, that as the Mexican economy grows its population growth rates will continue to decline.

So I think they have tackled the issue, but must still address the problem of the flood of new entrants onto the labor market that will occur as a result of previous high population growth rates.

Senator MATHIAS. What about the costs of education, health care, and all of that as the population grows?

Mr. FEINBERG. I think one of the things that Mexico needs to do is a major tax reform program, because in Mexico, people look essentially to the government for their educational system and to a large degree for the health care system. This creates a tremendous burden on the government.

One of the most important things the government needs to do now is to improve its tax collection system and reform its entire tax base so that it can afford those programs.

I think those programs, by the way, should not be seen merely as welfare programs. They are essential for the industrialization process that Mr. Means talked about so correctly, in my view: that in order to have an educated, healthy labor force, you need a labor force that has benefited from a set of social programs.

Senator MATHIAS. Do you agree with that, Mr. Means?

Mr. **Means**. I do, although I would want to elaborate on one point.

I said during my testimony that I thought the key factor was political will and political and economic conditions that will allow a country to move ahead.

Again, it seems like a curious comparison, but I would compare India, on the population issue, to Mexico. India was the basket case of the Club of Rome as recently as 5 years ago. It was going to start to death. It is now the miracle of the Green Revolution. It is exporting grain. It exports grain to the Soviet Union for oil, which has to embarrass the Soviets somewhat, I would think.

There are miracles that could occur when a country exerts political will. I am not persuaded the key economic problems in Mexico relate particularly to the debt or to population. I think it relates to a willingness to really confront the issue, to take serious action and to do something about it. The examples of India, Korea and a number of other countries in the developing world point in that direction.

Korea is the fourth largest debtor country in the world, facing the same high interest rates that we talked about earlier. Yet it has a very effective debt service ratio and is moving ahead very aggressively, because it has a very strong political will.

Senator **Mathias**. Mr. Magid, to what extent have the banks already written off portions of the Mexican loans?

Mr. **Magid**. Clearly it is difficult to speak for the banks in general, but I think it is important to comment that any prudent bank—and I would assume that that is every bank that is operating in the United States at this moment—would take a look at their portfolio and follow the normal credit standards associated with the risk. What that would mean is that they take a look at the private credit risk and then they take a look at the country risk.

So you can assume that banks that have obligations with Mexico, particularly the private sector, and the state banks, will have examined the credit worthiness of those institutions that do not have a government guarantee, who have established some sort of credit criteria, either a writeoff or a building up of a reserve associated with a classification.

In addition, all the major banks that I am familiar with have a country risk reserve system whereby they set up a percentage of that portfolio as a reserve to take an account of country risk conditions.

So, to imply that the banks have not been looking at the risk out there is incorrect.

One may argue over the relative analysis of that risk and what the reserve level should be, but they have been actively taking prudent credit actions.

Senator **Mathias**. Aren't the banks in a significantly better position today than they were, say, in 1982? Their capital bases have increased. If you look at the risk in relation to your total assets, total assets have increased. So aren't banks in a better position to handle this than 4 or 5 years ago?

Mr. **Magid**. That is 100 percent correct. That is one of the most striking successes, I would think, of this period since 1982, that the banks' exposure in the developing world relative to their total assets has declined significantly. This means that they are in a much stronger position to withstand any shock. And, in addition, their capital base has increased relative to that exposure. Again, this is an indication of their agreeing to assimilate any shock.

I would like to clear up one point where it was said that the banks suddenly stopped lending. I think the issue to keep in mind is that through the adjustment process, the banks were asked to be parties and contributors to the process in general and, let's say in the case of Mexico, the bank exposure was growing by 3 or 4 percent, though most banks' capital base was increasing at a higher percent, and the banks were actively looking for opportunities let's say to further their commercial interest. Let's keep in mind that the original premise of the exercise was that we would have a return to a voluntary lending environment—i.e., the banks on their own would make loans to private companies or even State corporations.

In fact, many banks were already talking about going to Mexico on a voluntary basis prior to the oil shock. And the market, it seemed, was ripe then for the banks moving in, beginning to make loans to the private sector, trade related financing, financing of investments prior to the oil shock, and I think that process will take place; but now it has just been postponed a few years.

Senator MATHIAS. Dr. Roberts, you have mentioned that Mexico could improve its situation by converting the debt into equity, or at least some part of it into equity, selling off national institutions. Let me ask if, in the years in which you have been watching Mexico, you have watched out of the corner of your eye what has been happening here, specifically ConRail.

Mr. ROBERTS. You mean that they don't want to sell.

Senator MATHIAS. Well, the political difficulty that the United States of America, with our tradition of free enterprise, is having in denationalizing ConRail.

Mr. ROBERTS. But we do not have quite the same level of crisis to encourage us that the Mexicans have.

Senator MATHIAS. Granting that, we also do not have the kind of tradition and political system and social and economic system which has brought them to this point. Now I am not saying that it is a desirable position for them to be in, but we cannot ignore the history that produced it.

Mr. ROBERTS. Well, I did not say that it would be easy for them, and I am sure if they would do it, they would be attacked for selling out the country.

But you have to consider that it is something the British have been doing fairly steadily, and apparently the French now are determined to denationalize.

So it is something that governments with a long tradition of socialization sometimes do change their minds about.

I think India is another example, and it is a Third World example, which used to be full of the most extreme kinds of rhetoric. So I would not want to say that I don't think the Mexicans can bite the bullet or do something sensible because if we say that, then we have to say what are we going to do about the situation.

Senator MATHIAS. I do not disagree with your recommendation. I am just pondering the kind of difficulties that it will engender, the kind of political problems it will create, and ways in which we might be able to facilitate in some helpful way, rather than simply laying it down as a sort of mandate out of Washington.

Mr. ROBERTS. Well, I propose that you put it together with some way of helping the banks write off some reasonable amount of the debt.

Senator MATHIAS. Mr. Feinberg, you looked as though you wanted to make a comment, before my time has totally expired.

Mr. FEINBERG. Thank you.

I think the issue of debt to equity swaps is one aspect or one contributing element that can help to work out the debt problem. But it is only one out of many that will have to be called upon.

It is clear that Mexico is not going to sell off PEMEX or most of its major Government companies. The figure of 1,000 firms that people talk about in the state sector is tremendously inflated because many new nationalizations occurred as part of the bank nationalization that Senator Helms referred to. So it has only been in the last few years that you had this big number of State-owned firms, and some of these, particularly smaller firms, will eventually be sold off. Some of them might be swapped as equity for debt.

However, a lot of firms were in the public sector in the first place because they were losing money and the Government took them over to save jobs. In other words, they were not good companies. So it is going to be hard to find buyers for a lot of those companies, I think.

Mr. ROBERTS. Senator Mathias, may I just clear up one ambiguity about this debt/equity swap.

Actually, there are two things involved here. One is that the Mexican Government takes existing assets it has and sells them and uses the funds to pay down its debt. That is the way this term is being used, so far as I can tell mainly in this hearing. But it has another meaning, perhaps more correct, and that is that the Mexicans accept foreign investment on the terms necessary for it to show up, and, therefore, they do not rely on debt or increased bank loans to finance their economic development, but that they rely on an inflow of private investment.

That is what I really mean by the debt/equity swap.

Senator MATHIAS. Recognizing a free market in capital.

Mr. ROBERTS. Well, they may as well recognize it. It is very difficult when you decide not to. That is one thing that we found tends to embarrass governments. When governments get in the way of that, they usually get run over by a locomotive.

Mr. MAGID. If I could just make one observation on this issue, it would seem to me that the debt/equity program that is taking place in Mexico and which the Mexicans have said they could envision being as much as $100 million a month is an excellent example of how the system is working. You have a number of smaller regional banks that may have gone into Mexico in 1980 or 1981 for, let's say, reasons that were not related to their overall strategic vision of the world and have decided now that they would prefer to cash out at a discount. They therefore do so.

You find investors who are willing to go into the country, create investment, hire people and hopefully move toward solving the country's medium term problem. At the same time, banks that went into Mexico with a longer term vision, continue to have that paper on their books and continue to have a long-term future in Mexico. And by the fact that they have that choice and they have elected to go forward, are most likely to be willing to be part of a medium term adjustment process, even if that entails new money.

I should add that when we talk about piling debt on top of debt, one also has to be very careful to look at how that debt is utilized. IMF money is used to build up reserves, to insure proper liquidity. The World Bank money is being used to finance specific programs and projects. The commercial banks would like to envision that their money, as it is going forward, is supporting the investment budget.

So I think we have to be careful and not just talk about the levels of debt but the end utilization of that money.

Mr. ROBERTS. I think the most important thing we have to be careful about is the public relations approach to economic policy because it misleads everyone.

Senator HELMS. Senator Murkowski.

Senator MURKOWSKI. Thank you, Mr. Chairman. I will be rather brief.

I think the ability to appropriately address the role of the United States in assisting Mexico is obviously your charge and that of the committee. Mexico obviously has given this dilemma a good deal of attention. To suggest that we should focus in on social problems or the issue of nationalization of Mexico's industrial capability, all of which are aspects the problem, I think obscures the reality that the Government of Mexico has to make some very basic decisions. In the testimony of Mr. Feinberg, that was suggested—the need for a new deal.

However, Mr. Feinberg, I thought I heard in your testimony an inference that somehow the hard, cold world of the financial community should morally reward the good intentions or past performance.

While I do not disagree with the merits of the application in the sense of fairness, we all know that reality dictates that what we are really measuring here is risk. As the risk increases, the ulcers of the financial community increase. If they want to go in for new money investment, they want higher rates because they need a higher return to offset that risk.

So I wonder, Mr. Feinberg, whether we could really expect the financial community to voluntarily just be good guys when their responsibility is to their investors and their shareholders. As we look for a way out, as the chairman asked the question, how much debt is out there? And how much would the Federal Government have to come up with to bail out Mexico? Are we engaging in wishful thinking? Because the banks are not going to voluntarily do anything. They are not going to voluntarily write off a loan if they think they can collect it, unless forced by the examiners to do so.

Mr. FEINBERG. Let me take this opportunity to raise a couple of points.

Of course, the banking system is politicized in the sense that that is why we have regulatory agencies, because banks are considered different from any other industry—precisely because they are at the center of commerce and production.

Senator **Murkowski**. Well, they have somebody else's money.

Mr. **Feinberg**. Yes; they also have somebody else's money: all of our money.

So, of course, the banking system is politicized.

You could see this in operation back in 1982. It looked like the banking system would destroy itself by pulling out of the Third World all at once and would thus leave everybody at a loss, because if everybody tries to pull out at once as the banks tried to do in a panic in 1982, nobody can take their money out. But what happened?

Paul Volcker and Jacques de Larosiere, the head of the IMF, stepped in. They called all the banks together and said that to protect everybody's interests, including the interests of the banks, we have to stay in—not lend as much as we did in the 1970's, which was excessive—but we have to continue to put in some new money. This, in fact, is the best way for all of us to preserve the existing assets out there.

And the banks agreed that new lending was, in fact, in everybody's best interest.

Senator **Murkowski**. Now, in your statement you said that to support Mexico's reform program, the U.S. Government and international lending institutions should lead the commercial banks into doing their part.

Is that what you are talking about, specifically?

Mr. **Feinberg**. What I am suggesting is what I think Mr. Mulford has suggested in a recent speech in Phoenix, and is also what Jacques de Larosiere, the Managing Director of the Fund, has also suggested in some speeches: that the net capital outflow from Mexico today and from Latin America is so large that it is equal to 5 to 6 percent of their GNP; that they do not have enough money to invest.

Without enough money to invest, you won't get that new manufacturing sector going that everybody is looking for to generate exports. You won't have enough money to cover budget deficits, social programs, et cetera.

So, therefore, it is in everybody's interest for the banks to do one of two things. There is an equation here.

There is a net outflow to the banking sytem; that is to say, they are receiving a lot more in interest payments from Mexico and from Latin America as a whole than they are putting in in net new lending. That generates a net capital outflow.

In my view, the banks can choose. They can either decide to put in some more money and reduce the net outflow in that way, which is what they have done traditionally and generally continue to do because it avoids their taking losses or write-downs; or they can say, "Well, OK, we don't really want to put in any new money, so we have to look at the other side of the equation. We will just have to take less in payments in one way or another." And there are many ways to do that. Debt/equity swaps is one; interest capitalization is another; partial loan write-downs is another. There is a wide menu of approaches toward that.

I think that is the equation which the banks have to look at, and they can choose which side of the equation they want to work on.

Senator MURKOWSKI. Well, that is true up to a point. The regulatory authorities come in and dictate certain policies with regard to capital adequacy and loan risk and the adequacy of loan loss reserves, all of which dictate to some extent the amount of flexibility that the bank may have.

In any event, what is inconsistent with the bank dictating the terms, rather than the political community, in which it would continue to loan in the Mexican environment? Perhaps I would ask our banker, Mr. Magid, this question. As you know, when you have a problem loan and you are working with somebody, you dictate the terms under which you will continue to maintain that relationship.

It would seem, as Mr. Feinberg suggested, that perhaps we should urge the commercial banks to do their part. But we do have certain constraints within the banking system. They can't just do anything they want.

Is there not general agreement that certain steps have to be taken by the Mexican Government to help themselves? Can't the industry—the banking industry and the financial community—indicate to Mexico specifically what they must do to get their act together so that you will continue to lend in that society, whether it is breaking down the nationalization of industries, or other actions? Why don't you treat them just like any other customer?

Mr. MAGID. I think, in essence, that you are hitting on a very important point, that we do. It is a little different, of course, when you are dealing with a sovereign country to use the term "dictate." So therefore what the commercial banks will do is they will say to the Mexican Government we are prepared to be a party in the process if there is going to be a financial engineering program.

Senator MURKOWSKI. Have you indicated that to the Mexican Government in regard to the credits that you lend to Mexico?

Mr. MAGID. In the sense of what our current conditions are?

Senator MURKOWSKI. In the sense of what your conditions are to continue your relationship?

Mr. MAGID. Yes, that is what I was going to say, in terms of waiting that they reach an agreement with the International Monetary Fund to deal with the size of the fiscal deficit, insuring or waiting for them to come to an agreement with the World Bank to insure that the structural changes are in place so that they can repay those obligations over the medium term.

So, to that extent of saying that we want to make sure that the IMF and the World Bank have also given their endorsement to a program, we do, indeed, give our terms and conditions. That is what a term sheet is. It is a series of terms and conditions.

We also do have the restraint that was passed in the last bill by the U.S. House and Senate regarding the banks and their lending policies, that when there is new money involvement from the banks, there should be an IMF program in place. We are dictated to, to an extent, by the U.S. Senate and House in that area.

Senator MURKOWSKI. Well, while you are dictated to to some extent, the question is: Are you going to have to cover your own risk in the sense of an advance on a credit, or is that risk covered through some type of guarantee? You know, a lot depends on the terms and conditions of the International Monetary Fund and so forth. Are you first in and last out? There are all kinds of concerns.

My point, Mr. Chairman, which I do not want to belabor, is this.

It would seem to me that the matter of continued support for the Mexican financial community in the current crisis depends to a large degree on the sophisticated financial community that is going to lend to Mexico under certain terms and conditions. The question for this committee is whether there is any liability to the Government of the United States, either through a guarantee program, or a contribution to the International Monetary Fund as a grant, as opposed to a loan. I do not sense the meat and potatoes of this issue coming out of this testimony, and I do not necessarily know that I would expect it. But that is what I am grasping for because we obviously have a tremendous obligation to think this through, in terms of our own self-interest as well as our relationship with Mexico.

But we also have a very sophisticated financial community that is out there for a return on investment and that knows how and under what terms it will continue credit with someone who has problems. I would encourage more input from that sector to this committee so that we can better understand what the ramifications and the necessary cures are going to be.

My question still is: Are we talking about additional liability to the Government of the United States through guarantees and grants, or whatever? Or do you people have the sophistication, and I think you do, to handle it yourself under certain terms and conditions dictated with regard to the reforms that the Mexican Government is going to have to undertake?

Thank you, Mr. Chairman.

Senator **Helms**. The Senator has stated the case perfectly, and I think it has been very helpful to have the testimony this morning.

Again, I thank all four of you for your patience.

I opened this hearing, Mr. Chairman.

Would you close it.

Senator **Mathias**. I would be happy to close it forthwith.

I think that perhaps one of the answers to Senator Murkowski's question is embodied in that ancient wisdom that if I owe $1,000 I am in trouble; but if I owe $1 million, the bank is in trouble.

Senator **Helms**. Right.

Senator **Mathias**. So, on those words, the subcommittees stand in recess, subject to the call of the Chair.

[Whereupon, at 1:25 p.m., the subcommittees adjourned subject to the call of the Chair.]

APPENDIX

PREPARED STATEMENT OF PAUL CRAIG ROBERTS

Mr. Chairman, members of the committee, I have been keeping an eye on Mexico since 1981 when Federal Reserve chairman Paul A. Volcker unexpectedly plunged the world into recession and collapsed the prices of commodities that were the basis for debt service and loan repayment by Third World debtors. Overnight the great achievement, as it was called, of petro-dollar recycling through financial intermediaries, such as U.S. banks,was turned into a very big problem. The Federal Reserve--indeed, the entire U.S. government--was slow to recognize the massive problem that had been created by the Federal Reserve's serious departure from Administration policy. It was not until the summer of 1982 when Mr. Volcker received the telephone call from Mexico that he realized that he had collapsed the asset values underlying the world debt structure, thus creating a serious financial crisis.

Banks had lent large sums to Third World governments based on projections of higher oil, copper, and other prices. The inflationary decade of the 1970s had taught the banks that inflation was a way of life and that growing export earnings from oil revenues would make it easy for Mexico to handle its debts. When the U.S. inflation rate collapsed suddenly and unexpectedly by nine to ten percentage points between 1980 and 1982, the banks began to realize that the price projections on which they had based the loans would not materialize and that they had seriously over-exposed their capital. Between 1982 and 1984 U.S. banks stopped lending, and U.S. capital outflows dropped from $119 billion in 1982 to $20 billion in 1984.

This extraordinary decline in the supply of dollars in foreign exchange markets pushed the price, or exchange value, of the dollar sharply higher, which further increased the burden of the loans on the debtor countries. The collapse in U.S. capital outflows was also the source of the large U.S. trade deficit, which increased protectionist pressures and raised further doubts about the ability of debtor countries to service their debts by selling us their products.

The crisis was avoided by lending money to pay interest, which increased the debt burdens of the debtors and passed the sinking ship on to the future. At the time, former Treasury Secretary William E. Simon, former chairman of Chase Bank George Champion, and I expressed skepticism of the approach taken, but the Congress and the public were assured that increased funding for the IMF was the solution. Perhaps bank economists and public policymakers believed that the U.S. domestic budget deficit would soon revive inflation and solve the problem and that a temporary bridge loan was all that was needed.

The lack of foresight to deal realistically with the problem has turned an economic problem into a diplomatic and foreign policy problem. Moreover, the latest proposals to deal with the economic side of the problem have the potential of worsening the political problem. Consider, for example, the proposal for "structural development loans." In practice such loans are likely to be indistinguishable from long-term balance of payments support. In a competitive political process, the loans are certain to be exposed as a clever disguise of the use of taxpayers' money to bailout private banks and foreign governments whose own internal problems cause them to be often hostile to our foreign policy. The corrosive impact on the public's confidence in U.S. government policy is a high cost to pay, and in the end it will serve no one's interest.

Mr. Chairman, there is no doubt in my mind that Mexico has serious problems--problems that go beyond their external debt--and that Mexico's problems are our problems too. The question is: how are we going to handle them? So far the moves have been in the wrong direction. The politicization of the debt crisis is interweaving the future of free banking in the United States and the prestige of our foreign policy with the fate of a one-party state whose image is suffering from the appearance of excessive corruption and a massive flight of people and capital from its borders.

It is clear that piling debt upon debt and exposure upon exposure have only worsened the problem. Changing the rationale for loans does nothing to reduce their burden. Too large a share of the loans was squandered in theft and unprofitable investments. The share that was profitably invested cannot carry the full burden. The loans cannot be bailed out. They can only be bailed out from under. This means someone has to bite the bullet.

Mexico could do it by converting the debt, or some share of it, into equity. This would mean that nationalized enterprises would have to be sold, with foreigners holding large interests. There is no doubt that the Mexican government would be accused of selling out the country. But if it worked, the flight of human and financial capital would stop and even reverse, and that would silence the critics, or at least allow the government to survive the policy.

The banks could do it by writing off the worst of the loans. This would simultaneously reduce the exposure of the banks and Mexico's external debt.

A good solution would be to wrap both approaches into one package that would reduce Mexico's external debt to a manageable level.

Mr. Chairman, practically any solution, including default, is preferable to the long-run politicization of the debt. I would rather buy the banks out than to have a captive U.S. foreign policy.

The Mexicans have succeeded as a one-party, corrupt state because of their expertise at manipulating the political symbols of the left. The leftwing rhetoric generated an emotional satisfaction for the American political left that deflected the hard scrutiny that toppled Marcos and others. I do not say this out of hostility to Mexico or the American political left. I say it as a fact that has strategic consequences. Sooner or later someone on the American political left is going to write an article denouncing the Mexican government for soiling sacred symbols by using them to mask political corruption. When the inevitable slide begins, it would be highly desirable if U.S. financial institutions and foreign policy are not involved in propping up the Mexican government.

The Mexicans are unlikely to change or alter their political and economic arrangements as long as we subsidize them with capital flows. The way to change these arrangements is to cut a deal on the debt that diverts control of resources from government to private hands. This means cutting the debt down and not building it. And it means privatizing the Mexican economy by converting debt to equity. No one needs to be left out of the bullet-biting.

If something realistic is done, Mexico has a good chance. If something political is again done, the sinking ship is simply passed on. One thing about sinking ships: they eventually sink. With the communists solidifying their hold on Nicaragua, the sinking of the Mexican ship of state has a lot of implications for the United States.

Adding to the debt is bound to increase the politicization of the debt. Last week President de la Madrid again reiterated his charges that foreign creditors are choking the nation to death. It is not implausible that the Mexicans will respond to their problems by adopting a more extreme political rhetoric to counter the image of economic failure and political corruption. In the end they may simply set themselves up for the communists.

The quicker the debt is curtailed by writeoffs and conversions to equity, the less likely Mexico is to sink.

Avoiding the Global Debt Quagmire

Four years ago, in the wake of the near-defaults by Mexico, Brazil and other debtors, the U.S. government embarked upon a several-pronged strategy aimed at averting what seemed to be an imminent crash of the international financial system. The Treasury's Exchange Stabilization Fund provided short-term emergency loans to some of the near-bankrupt borrowers. The Federal Reserve prodded commercial bankers to recapitalize interest payments coming due. The International Monetary Fund was given expanded resources and a central role in defining and enforcing policies for debt-burdened countries that would translate into an exportable surplus necessary to continue servicing their debt.

The Congress and the public were assured that these measures would gradually relieve the strain on the banking system, restore access of debtor countries to private credit and lay foundations for renewed economic growth in the world.

A few observers, myself included, expressed misgivings about the approach taken to the debt problem. We felt uneasy about the use of the Treasury borrowing capacity for providing the governments of debtor countries, directly or through the IMF, with funds to service their debts to private banks. The absence of a convincing rationale for the preferential treatment given by the U.S. government to the indebted Mexican oil industry over oilmen from Oklahoma or the developers of Brazilian timberland over lumberjacks from Oregon undermines the public's confidence in the integrity of the U.S. government. We felt that if for the sake of a higher public benefit, such as the preservation of a stable financial system, the taxpayers are called upon to assume some risk on behalf of private lenders, the government must be open and candid with the American people about the true nature and cost of the rescue operation. We also doubted that piling debt on debt and exposure on exposure would lead to a resolution of the problem. It seemed clear enough that the day of reckoning is only postponed by imposing on the debtor nations austerity programs as a quid pro quo for providing them with new loans to pay interest on old loans.

The Road from Toronto to Seoul

At the 37th annual meeting of the IMF and the World Bank held in 1982 in Toronto, the substance of all discussions about the prevailing economic and financial conditions in the world could be summarized in one alarmist cry: "The sky is falling." This helped to produce a bailout, and at the 40th annual meeting of these institutions held last autumn in Seoul, Treasury Secretary Baker could congratulate everyone on the progress achieved in the intervening three years in resolving the debt problem. He pointed out, in particular, that aggregate current account deficits in developing countries have been sharply reduced while real growth rates have risen. Furthermore, a number of the debtor countries succeeded in rescheduling their debts and replenishing their foreign exchange reserves, thus staving off an imminent danger of a liquidity squeeze. This bought some time for the major lending institutions as well. Since the onset of the debt crisis in the summer of 1982 the affected banks have managed to increase their capital base and in the process have brought down their lending exposure in most troubled debtor countries relative to their capital. Listening to the Treasury Secretary, one might have been tempted to conclude that we are out of the woods or, at least, on our way out.

One problem with the public relations approach to policy is that it misleads everyone. Whatever improvement in the debtors' external position that occurred on the road from Toronto to Seoul was in large part a direct result of the American economic revival. Rapid economic growth in the United States in 1983-1984 made it easier for the less developed countries to increase their exports, while falling U.S. interest rates helped to moderate the rise in the cost of servicing their debts. Moreover, the improvement in the debtor countries' current account attributable to an IMF-engineered curtailment of their imports was achieved at an enormous cost to those countries.

This cost is reflected in the stark fact that the gross domestic product per capita in major troubled debtor countries (those that had to reschedule their debts) is on the average about 10 percent below its pre-crisis level. For many of them, like Mexico, Peru, Venezuela and the Philippines the decline has been closer to 20 percent, with Chile and Uruguay experiencing even larger declines. The drop in their citizens' living standards has been commensurate. (For the sake of comparison, at the trough of the 1981-82 recession, income per capita in the United States was some 4 percent below its previous peak). Obviously, any more such accomplishments and we will be faced with starvation on a world scale.

In spite of these sacrifices, the strategy did not produce a long-term solution to the debt problem. While the reduction in debtor countries' current account deficits was dramatic, there is much less here than meets the eye. Part of this improvement is simply due to a series of postponements or stretchouts of interest payments. Not surprisingly, while the ratio of scheduled interest payments to exports of major rescheduling countries was about 8 percent lower last year than it was in 1982, the ratio of their gross external debt to exports was some 20 percent higher. According to the World Debt Tables released recently by the World Bank, the long-term external debt burden has risen considerably in the last three years, despite a significant drop in interest rates and a surge in debtors' exports to the United States. In this most crucial respect, the debt strategy has proven to be a dismal failure.

The strategy has also fallen well short of its other goals. Inflation in most debtor countries has risen sharply. Public sector deficits have been reduced somewhat, but largely at the expense of public capital formation rather than current expenditures. Net foreign direct investment inflows have fallen by approximately one half from their 1982 level. Net capital outflows from those countries, albeit smaller than at the height of capital flight in 1982, are still more than twice the amount of their net borrowing from commercial banks. National savings as a share of domestic income keeps falling and gross domestic investment as a share of domestic output keeps falling even faster. These trends, needless to say, do not bode well for future ability of major rescheduling countries to service their external debts.

From Seoul Onward

Statements by Presidents Alfonsin of Argentina, Garcia of Peru and de la Madrid of Mexico have made it clear that IMF austerity programs and a rising debt burden are unlikely to lead to a happy ending of the debt problem. Just as this policy unraveled, Treasury Secretary Baker was on the scene with his "Program for Sustained Growth" which rests on three pillars:

--The adoption of sound market-oriented economic policies by major debtor countries;

--"Structural adjustment" lending in place of project lending by multilateral development banks;

--Increased lending by commercial banks.

The emphasis on market-oriented policies is an improvement. Nevertheless, the Baker plan indicates that not enough lessons have been learned.

It should be clear by now that economic policies, however sound, cannot be forced upon the debtor countries by pursecontrolling international bureaucracies. This will only breed popular resentment and xenophobic hostility. Moreover, it is an erosion of free banking for the Treasury, the Federal Reserve, and the IMF to instruct private banks to whom and how much to lend. If any such loans go bad, bankers would be justified in invoking the government's complicity, which could lead to taxpayers' participation in covering their losses. Worst of all, lending by multilateral development banks (MDBs) for "structural adjustment" is barely distinguishable from long-term balance of payments support. It undermines confidence in governmental institutions by arousing suspicions that public monies are being used in backdoor ways to service private debts.

All of these are steps in the wrong direction. Nothing is gained by having the U.S. government and international institutions become even more intimately involved in the management of private lending or by increasing the exposure of commercial banks or the debt of the debtors.

The correct approach is to reduce the vulnerability of both lenders and borrowers. Since the banks' financial conditions have strengthened, regulatory authorities could become stricter in forcing accelerated writeoffs of unrepayable loans. As this would be tantamount to banks' forgiveness of some debts, it would result in a decline in the borrowing countries' debt burden and, simultaneously, a reduction in the banks' foreign exposure. Banks could also be encouraged to sell off to risk-taking investors some of their loans to those countries. While such sales would result in a decreased book value of their assets (and, in many cases, diminished current earnings), the bank would reduce their foreign exposure and get an infusion of cash.

Additional loans to troubled borrowers could be made contingent on their willingness to take concrete measures leading to an easing of their debt burden. A good place to start would be for the governments of debtor countries to sell a number of nationalized enterprises. It is possible that large blocks of shares of these enterprises might be purchased by local residents repatriating their funds from abroad. The British government has in recent years sold many nationalized enterprises without a discernible loss of national pride by the population. It is difficult to see why the Mexican and Brazilian governments cannot dispose of their own white elephants.

It is imperative that the process of politicizing the debt be stopped. The correct strategy is to dilute the dominance of governmental and intergovernmental institutions in foreign lending and investment. The debt problem must not be used to erode the privateness of U.S. commercial banks.

CSIS

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The Honorable Paul Craig Roberts has the William E. Simon Chair in Political Economy at the Center for Strategic and International Studies, Georgetown University.

During 1981-82 he served as Assistant Secretary,of the Treasury for Economic Policy. President Reagan and Treasury Secretary Regan credited him with a major role in the Economic Recovery Tax Act of 1981, and he was awarded the Treasury Department's Meritorious Service Award for "his outstanding contributions to the formulation of United States economic policy."

Dr. Roberts' latest book, THE SUPPLY-SIDE REVOLUTION, was published by Harvard University Press in 1984. Widely reviewed and favorable received, the book was praised by FORBES as "a timely masterpiece that will have real impact on economic thinking in the years ahead."

During 1975-78 Dr. Roberts served on the Congressional staff where he played a leading role in developing bipartisan support for a supply-side economic policy. Dr. Roberts has held many academic appointments and enjoys a world-wide reputation for his work in scholarship and in public policy. A former editor and columnist for the WALL STREET JOURNAL, he is currently a columnist for BUSINESS WEEK.

Dr. Roberts was educated at Georgia Tech, the University of Virginia, the University of California at Berkeley, and Oxford University where he was a member of Merton College. He has published a large number of articles in journals of scholarship and the national media, including the JOURNAL OF POLITICAL ECONOMY, OXFORD ECONOMIC PAPERS, JOURNAL OF LAW AND ECONOMICS, JOURNAL OF MONETARY ECONOMICS, PUBLIC FINANCE QUARTERLY, PUBLIC CHOICE, ETHICS, SLAVIC REVIEW, SOVIET STUDIES, THE PUBLIC INTEREST, HARPER'S, WALL STREET JOURNAL, NEW YORK TIMES, WASHINGTON POST, FORTUNE, BUSINESS WEEK, LONDON TIMES, and other publications in the United States and Europe.

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PREPARED STATEMENT OF GRADY E. MEANS

I greatly appreciate the opportunity to be able to address the Members of the Committee on the subject of the current Mexican economy and potential problems that may arise over the next couple of years.

I am Grady Means and I manage the International Business Analysis group for Coopers & Lybrand. The group performs ongoing economic reviews of over 100 countries worldwide and assists large U.S. clients in planning overseas ventures. Our Group also draws upon the firm's 515 offices worldwide for detailed information on local economic and market conditions.

For the most part, my comments will be drawn from a report just released by Coopers & Lybrand entitled the 1986 Annual Report on the Worldwide Economic and Business Climate. The report reviews countries and regions worldwide and attempts to provide an objective assessment of current economic and business prospects of nearly 100 countries.

Mexico plays a key role in our assessment as is evident throughout the report. The declining price of oil and huge foreign debt has put tremendous pressure on the Mexican economy which could lead to severe crisis. In 1986 Mexico might be considered the one developing economy whose economic problems could have the greatest impact on the U.S. from an economic and political perspective. In that light, in our view, it is most appropriate for the Committee to be holding extensive hearings on current conditions in Mexico and their implications for the future.

In drawing from our 1986 economic report, it is useful to place conditions in Mexico into the broader context of the world economy. The report traces two major themes, captured under the term "commoditization," which more than anything else suggest the problems that are being confronted by countries like Mexico.

Commoditization has two aspects. The first aspect is that most goods normally termed commodities -- fuels, minerals, other raw materials such as lumber, food, etc. -- are in excess supply on the world market and are selling for prices that represent record lows in real terms -- and these conditions will probably continue for ten years. For several decades there was a close linkage between a country's commodity base and its ability to generate GNP. With few exceptions, countries which had relatively strong commodity resources, could rely on relatively secure GNP growth rates. This linkage has been broken within the last couple of years, and, for at least the next decade, most commmodities will be generating low prices in the world market.

The second aspect of the "commoditization" theme is that nearly all goods and services, no matter how high tech or secure their current market niche, are increasingly resembling commodities from an economic point of view. Growing global competition, with many developing countries becoming successful manufacturers, combined with the new phenomena of low inflation economic recoveries and low basic commodity prices, has meant that even the most high tech goods -- from microcomputers to biotechnology -- must compete on the basis of price as well as value. To be truly competitive in the world market, successful companies must produce the "high-quality/low-cost" products by world standards in the market -- a new definition of commodity. This suggests very aggressive global competition in which the most successful companies or countries are those which manufacture the highest "value-added" goods or provide the highest "value-added" services in the world economy.

What this means for the next decade is that the countries that will be the most successful in economic and financial terms will be those which are less reliant on commodity exports and increasingly reliant on value-added goods and services exports which are competitive by world terms. In short (and the report elaborates on these themes for great detail) countries must strive for increasing manufacturing productivity and for finding the "value added" niches in which they can be truly competitive in the world market.

Mexico is the archetype of major developing economies which must undergo the critical transition from a commodity-based economy to a value-added manufacturing economy over a very short period of time or face serious crisis.

The economic report reviews a number of key themes in the world economic and financial environment and describes how Mexico is, along with other countries, affected by these trends.

The world debt crisis continues and worsens for countries like Mexico, which faces an enormous debt burden and a high debt service ratio as well as the decline of its major foreign exchange earner; oil. For the developing world as a whole, the debt crisis is stabilizing somewhat with total debt burden beginning to plateau in aggregate across the Third World. While heartening, this is not a satisfatory situation for any country since continued debt pressure requires sustained austerity measures which eventually have a political impact. It is important for debt pressure and burden to lessen for a country if it is to be able to grow and ease what are extreme political pressures. For Mexico, the pattern is worse since oil generates nearly 70 percent of its foreign exchange and the price of oil is rapidly declining, thus reducing Mexico's capability for making its debt payments.

The report compares Mexico to Brazil from the perspective of the mix of its economy and its competitive exports. As the report notes, Brazil has been able, over the past twenty years, to move from a commodity-dependent economy -- 55 percent of its exports in 1962 were coffee -- to an advanced manufacturing economy which produces high tech manufactured products which are competitive in the world market with those of any country. Although Brazil carries an enormous foreign debt burden, the economy is somewhat "hedged" since it is not subjected to the extreme cycles of commodity prices. Mexico on the other hand is a commodity-dependent economy, and even more fragile since there is only one commodity; oil. From one perspective, oil may prove to have been a curse for Mexico and its economic prospects, since it masked many of the structural problems that were building in Mexico's manufacturing sector and allowed Mexico to forego improvement in its manufacturing capability which could have made it competitive. The high level of oil revenues in the late 1970's and the early 1980's, combined with cash from foreign loans into the country, gave Mexico the appearance of prosperity and economic success but hindered movement toward true value-added manufacturing.

During the 1970's, both Brazil and Mexico had relativey strong growth rates in the 4-6 percent range -- Brazil because it had a successful manufacturing economy, Mexico because it was able to generate an increasing level of oil exports. In the 1980's, the picture began to change dramatically with Brazil continuing to maintain relatively strong growth and forecasted to achieve a 5-7 pecent average annual growth rate over the next decade. This contrasts with Mexico, which is experiencing an unprecedented decline in its growth rate and may be fortunate to achieve a 2-3 percent average annual growth rate over the next decade in real terms.

A further useful comparison within Latin America is on the issue of inflation. Inflation is a key indicator on both sides of the long-term economic development equation. Countries must have a certain degree of political and economic stability in order to seriously tackle the problem of inflation without catastrophic political consequences. On the other hand, countries cannot regain conditions which support long-term economic growth and competitiveness without lowering inflation rates and reestablishing foreign investor confidence in their economy.

During the past two years, Argentina and Brazil have managed to achieve what must be called the "Latin American Economic Miracle." Both countries have been able to take advantage of increasingly stable democratic political climates in their countries, and the accompanying goodwill which these new political institutions have generated among the public, to tackle what had been murderous inflation rates of several hundred percent a year and lower them to remarkably low levels over a very short period of time. In the case of both countries, they established new currencies and promised "not to print money." They have both, thus far, kept to that promise and lowered their inflation rates to an annual rate of approximately 30 percent in Argentina and less than 10 percent in Brazil.

These policies of course must be accompanied by further economic reforms in order to have lasting effect, but the results so far have been very encouraging.

Mexico, by contrast, still suffers from a high inflation rate of between 60-100 percent on an annualized basis which leads to the continuing problem of dramatic currency fluctuations and devaluations, further eroding foreign investor confidence in the country. In the case of Mexico, however, it is not clear that a broad base of political goodwill and support exists and is sufficient to support the type of dramatic reform that both Argentina and Brazil have embarked upon.

The Mexican currency was again devalued over the past week and for the first time softened beyond 600 pesos to the dollar -- those with good memories may recall that the peso was valued at between 25 and 50 to the dollar as recently as 4 years ago -- meaning that Mexicans, relative to the U.S., have gotten poorer by approximately 25-fold over four years.

Pulling many of these themes together, our 1986 report described what we call our Competitive Vulnerability Index. This chart, which is somewhat simplistic, creates a ratio of manufacturing and machinery exports over material and fuel exports and arrays countries according to those which generate the predominant degree of their exports from value-added manufacturing and machinery and those whose exports are dominated by commodities such as materials and fuel.

The concept is that those countries which predominantly export manufactured goods and machinery will be more competitive in the world economy because their exports aren't subject to commodity swings, while at the same time such countries can take advantage of the cheaper raw material imports.

On the other hand, countries which are highly dependent upon material and fuel exports will be hurt by the downswing of commodity prices and thus will see some erosion in their economic position unless they begin to move quickly to develop value-added manufactured exports.

From this perspective, Mexico ranks with Venezuela, Indonesia, and Chile as one of the most vulnerable countries in the world from an economic and competitive perspective over the next decade. On the other hand, countries like Argentina, Brazil, and India as well as the rapidly industrializing countries of the Pacific Rim are considerably less vulnerable and thus expected to sustain a reasonable growth rate over the next decade.

But Mexico's fate is certainly not sealed. The country has many strengths which it could take advantage of and policymakers in Mexico are aware of this and will try to move in that direction to the degree possible. With all of its reliance on commodities, Mexico is still the tenth largest manufacturing country in the non-Communist world. As data in our economic report indicate, manufacturing output from Mexico exceeds that of such countries as Australia, Korea, Taiwan, South Africa, Argentina, Hong Kong, and Singapore. With renewed capital investment, Mexico could increase its manufacturing output further and become perhaps the eighth largest manufacturing country in the free world.

It is also useful to recognize that Mexico's growth has not been purely debt-financed. Between 1974 and 1984, 85 percent of Mexico's investment capital came from internal sources. This reflects a high level of capital formation within the country, and suggests that the human and physical capital exist in Mexico to become a strong and competitive economic force if the policy climate permits movement in that direction.

In short, Mexico has many serious problems, but opportunities still remain to correct those problems and return to sustained economic growth.

The normal formula for such change involves reattracting private investment capital back into Mexico and developing a value-added manufacturing economic base. From the experience of many developing countries attempting to achieve these goals, the usual recipe involves privatization, lessened protectionism, a broadening of democractic and free market institutions, and related policies which restore investor confidence and utilize market forces to achieve truly competitive manufacturing sectors.

Mexico does not score well currently on any of these factors, and, as noted in the report, ranks relatively low from the point of view of movement toward privatization and lower protectionist barriers. Because of that, Mexican manufactured goods are considered to be relatively low quality and non-competitive by world standards.

In grappling with these issues the Mexican government is not unsophisticated. It is fully aware that it needs to reattract capital investment and that lessened protectionism and privatization would be effective steps in that direction. Nonetheless the political conditions in Mexico are some of the most complex in the Third World and may not allow for the types of institutional transitions that many analysts would prescribe. In that context it is useful to note that, although the normal formula for economic development is a useful guide, it is often politically difficult to institute and at times ineffective. Many countries have ignored some of these basic principles and still established highly competitive economies tailored to their local social and economic conditions. Japan has maintained many formal and informal protectionist barriers and nonetheless become one of the most vibrant and fast-growing economies in the world. Brazil from 1962 to 1984 was not a democracy but a state-run economy and yet achieved one of the most dramatic transitions from a commodity-based economy to a manufacturing economy of any developing nation in the world. In short, it is necessary to tailor programs to realities within the countries, and Mexico's realities are highly unique.

The factors that are absolutely necessary for a successful transition from a commodity-based economy to a modern manufacturing economy are the will to undertake such a program and the political-economy conditions to effectively execute it. Argentina, after 30 years of chaotic economic performance, and Brazil, after 20 years of increasing stale military rule, both found themselves with political conditions and sufficient political goodwill to execute their dramatic reforms.

Mexico is different and similar conditons have not developed there at this point. Nonetheless change is badly needed, and the Mexican government is very aware that more effective economic programs need to be developed.

U.S. policy could be of great help to Mexico but probably needs to address three issues:

- debt problems need to be stabilized so that Mexico can return to growth;

- on a separate track, selected assistance would be helpful to assist Mexico in improving its value-added manufacturing capacity;

- in addresing the above two issues, approaches must be sensitive to unique conditions in Mexico and must follow the Mexican lead, within the constraints of responsible investment strategy, if they are to be effective.

I hope this perspective on the economic conditions in Mexico is useful. Thank you very much. Copies of our economic report are available along with this statement.

PREPARED STATEMENT OF RICHARD E. FEINBERG

Mr. Chairman, I am delighted to have this opportunity to testify today on a matter of great importance to American foreign policy. Thanks in part to the work of your committees, American attention today is riveted on Mexico, and on the many interconnections between our two nations.

I am deeply worried about the state of U.S.-Mexican relations--and about U.S. relations with much of the developing world. In important respects, Mexico is now serving as a lightning rod for the multiple frustrations that many Americans feel toward the Third World more generally. Many Americans believe that we have poured billions of dollars of aid into developing countries to no avail. On the contrary, the Third World seems to be typified in the public eye by what I will call the five "Cs"--corruption, cocaine, capital flight, communism, and chaotic violence. The most prominent images of the Third World broadcast recently into American living rooms include Qaddafi's threatening fist, Imelda Marcos' 2000 pairs of shoes, Daniel Ortega's defiant smirk, and bails of confiscated marijuana. The U.S. media are full of stories regarding Mexican corruption, drug dealing, lawlessness, and capital flight.

These stories make for exciting reading. They also appeal to that part of our national character that prefers to see foreigners as less civilized than ourselves. You and I know these images are misleading guides to the complexities of developing countries. If the American people come to see them as the essential truth, it will be impossible for the United States Government to conduct a sensible and nuanced foreign policy. Policymakers will become prisoners of the popular imagination.

The Mexican system is deeply flawed--as is our own. But what I want to do in the next few minutes is to paint a picture of a nation that has suffered tremendously in the last four years, and that notwithstanding mistakes and hesitations is making major efforts to overcome past errors and remake itself into a more modern society. Rather than receive sympathy for its travails and recognition for its efforts, Mexico has faced escalating foreign criticism and demands for yet greater change. Now Mexico, too, is frustrated.

Two nations seething with mutual frustrations cannot be good neighbors.

The Debt Crisis

The Mexican economy has been subject to a relentless series of severe shocks. Interest rates on its $70 billion debt owed to foreign banks soared and remain high in real terms. New commercial bank credits, once readily available, have become increasingly scarce. The price of petroleum, which accounted for some two-thirds of export revenues, has plummeted. These disturbances were triggered by events largely beyond the control of Mexico.

Mexican policymakers were slow to respond to some of these shocks, but eventually had no choice but to adjust by slashing merchandise imports from $19 billion in 1980 to $11 billion by 1984. This correction was accomplished by a series of fierce devaluations and painful cuts in living standards. Starting at 26 to the dollar in 1981, the peso has been in a free fall which has taken it below 600 to the dollar. Industrial workers today earn some 30-40 percent less than in

1980. The government sector has also sacrificed: public expenditures in goods and non-financial services were shaved by 25 percent between 1981 and 1985, and the public-sector deficit as a percentage of GDP was reduced from a high of 17 percent in 1982 to 8 percent last year.

Consider what it would mean to strip American workers of one third of their income, and to cut U.S. fiscal spending by a quarter.

Mexico made these sacrifices while continuing to service its foreign debt. Over the last four years Mexico has devoted nearly $40 billion, and roughly 40 percent of its export earnings, to meeting its international financial obligations. This outflow has absorbed over 20 percent of total savings, and about 6 percent of GNP. If the United States were paying out 6 percent of its GNP, that would equal $240 billion. To place this sum in perspective, $240 billion is over two-thirds of our spending on national defense, and surpasses by half our entire trade deficit.

Since Mexico's debt payments have exceeded capital inflows by a wide margin, Mexico has been transfering resources to the United States and other creditor nations. In a reversal of logic and morality, Mexico has been aiding the U.S. economy--and on a scale that is massive in relation to Mexico's wealth. In essence, Mexico is helping us to finance our own trade and fiscal deficits.

Mexico has also helped maintain the international financial system throughout Latin America. At key moments when other debtors contemplated breaking the rules, Mexico counseled caution, and has repeatedly busted efforts to create a forceful debtor union against the creditors.

Expectations of rewards--and fear that hostile behavior would incite severe sanctions--explain Mexico's exemplary behavior. Mexico hoped that prudent financial management would lower its credit costs and reopen its access to private credit markets. It feared that aggressive tactics would provoke retaliation--the curtailing of trade credits and possibly the seizure of overseas assets--that could disrupt imports and stimulate a domestic financial panic. Consequently, the Mexican government considered it riskier to deprive American banks of their interest payments than to cut the wages of Mexican workers.

But the rewards promised for good behavior have for the most part failed to materialize. The commercial banks have lowered interest margins to pre-1982 levels and granted a multiyear rescheduling of outstanding principal. But Mexico's main objective--to regain normal access to new lending--has been frustrated. Instead, the banks have become increasingly critical of Mexico, and of Latin America in general; the banks' strategic objective seems to be to reduce their hemispheric exposure relative to their overall assets and their capital. So long as the banks' overriding objective is to lend as little as possible to Latin America, no amount of good behavior or economic reform is likely to call forth substantial amounts of new loans.

Mexico also assumed that it could gradually reduce the burden of the debt on its economy by increasing export earnings. Non-oil exports have grown from $4.7 billion in 1982 to $7 billion last year, but these gains have been more than offset by the projected $6 billion loss in 1986 export earnings caused by the drop in oil prices. Thus, Mexico has not been able to grow its way out of debt.

With the potential carrots withering, Mexican compliance has become a function of fear. But economic relationships held together primarily by distrust are inherently unstable.

The Current Stalemate

This year's oil price fall has destabilized Mexico's external and internal balances. The current account was thrown from near balance into a sizeable projected deficit, and lower oil prices have substantially inflated the budget deficit. Consequently, the peso is now under severe pressure despite very high domestic interest rates, and inflation seems to be escalating into the 100 percent range. Real wages are again falling, and real per capita income levels may drop by 5-7 percent this year.

Mexico initially anticipated borrowing $4-5 billion in 1986. When the oil price suddenly collapsed, Mexico sought an additional $4 billion to see it through this latest shock, but creditors turned a deaf ear. Humiliated, the Mexico government announced that maybe it didn't need the extra $4 billion after all.

The current impasse arises in large measure because the Mexican perception of the crisis is so different from ours. Many Mexicans are critical of their government's performance, but they also blame U.S. fiscal and monetary policies for high interest rates and unsteady global growth rates, and fault the international commercial banks for leaping from enthusiastic over-lending to frigid under-lending. Mexicans also believe that while creditors and debtors alike made mistakes contributing to the debt crisis, the debtors have been made to bear most of the burden of adjustment.

The Mexican government laments that the creditors fail to appreciate the reforms it has begun in order to lay a new foundation for long-term growth. In a major reversal of its wary nationalism, Mexico is negotiating entry into the General Agreement of Tariffs and Trade (GATT), and is working closely with the World Bank to reduce and rationalize its trade barriers. Regulations governing foreign investment have also been liberalized.

Meanwhile, the Mexican government is afraid that deepening austerity will stir domestic unrest. The Mexican workers and unions have been amazingly passive, but the ruling PRI worries about the omnipresent danger of spontaneous mob violence, and is anxious about upcoming state and local elections.

Some in the Mexican government are arguing that their good behavior on debt has merely led the banks to believe that they can continue to throw the burden of future adjustments onto Mexico. The banks' refusal to provide fresh money in response to the oil price shock fuels this belief.

Other Mexicans believe that the Reagan administration interprets compromise as weakness, and that the White House responds only to shows of strength. Some Mexicans go further, and fear that those in the United States who have long opposed the nationalism and statism of the PRI now see their opportunity, and will settle for nothing less than rolling back the Mexican revolution. In Mexico City, the influence of voices pressing for a harder line against the United States is rising.

As you are well aware, many Americans see a different picture. They correctly note Mexico's backsliding on its fiscal performance in 1985, perceive a lack of firm leadership following the recent oil price crash, and believe the trade and investment reforms do not go far enough. Some Americans even doubt whether the announced reforms will be seriously implemented. In short, the administration of President de la Madrid is suffering a credibility gap in the United States.

Capital Flight--A Digression

Critics of Mexico are pointing to capital flight as a sign that Mexicans themselves have lost faith in their system. The commercial banks ask, "Why should we make loans that will soon find their way back to Houston and Miami?"

Certainly, Mexican capital flight has reached damaging levels. But some degree of capital outflow is both normal and even beneficial:

--When American corporations or individual investors place their money in foreign currencies, it is called "portfolio diversification." Does the privilege of hedging against uncertainties belong only to residents of industrial nations?

--Mexicans who hold financial assets abroad have a stake in the international financial system. They become global citizens, and are likely to seek good relations with the United States. The fact that most influential Mexicans hold foreign assets helps explain Mexico's search for non-confrontational solutions to the debt crisis.

--Mexican capital has benefited U.S. interests. Capital inflows have helped cover our balance of payments and fiscal deficits. And the very same banks that decry capital flight are willing takers--are even active seekers--of foreign deposits.

--The U.S. economy is an overwhelmingly powerful magnet, especially when its extraordinarily secure financial assets carry high rates of return. By one measure, capital flight from Canada has been at least as great as from Mexico in recent years.

Both Mexico and the United States should take measures to reduce capital outflow from Mexico. But its persistence is neither abnormal nor immoral, and it is not in our interests to halt it entirely.

The Dangers Ahead

The deteriorations in the Mexican economy and polity, and in U.S.-Mexican relations, threaten both nations' vital interests. Both governments need to rethink current policies.

The Mexican political system is not on the verge of collapse, but the grip of traditional institutions is clearly weakening. The poor are alienated, the middle class is demoralized, and the government is widely viewed as indecisive, colorless, and distant. Mexico now faces a crossroad between two possible paths: increased political liberalization or repression; peaceful political modernization or obdurate insistence on the status quo.

Our own behavior is inadvertently weakening segments of Mexican opinion favorably disposed to the United States. Those Mexicans who advocate economic liberalization and increased integration into the global economy lose strength when Mexico is continually slapped by the international economic system. The perceived absence of rewards for good behavior tilts the debate toward those who advocate unilateral action. When we further heap public scorn on Mexican officials, we generate a negative, nationalist reaction among many sectors of Mexican society.

The Mexican financial crisis threatens to undermine the global U.S. debt strategy. If Mexico requires special treatment, other Latin American debtors will request the same. It will be difficult to prevent a domino-like contagion. Furthermore, the Baker Initiative may be mortally wounded unless the IMF and World Bank reach accords with Mexico--accords which are consistent with the Initiative's emphasis on renewed growth.

The dangers to both nations are great and growing, and rising bilateral tensions could hinder cooperation on a wide range of issues, including drugs, immigration, and border problems. This is also a moment to turn crisis into opportunity.

The Need for Two New Deals

Mr. Chairman, the Mexican economy needs a new deal. The Mexican government must come up with a package of bold measures that address short-term financial problems as well as structural obstacles to growth. Such a plan can only succeed with the financial and moral backing of the United States and the international financial community.

It is for the Mexicans to propose their own program, but major reforms are clearly and urgently needed in foreign-exchange management and tax policy. Following the praiseworthy examples of Brazil and Argentina, tough wage and price controls may be temporarily desirable to break the inflationary psychology. The Mexican government should then sit down with its private sector leaders and World Bank officials; building on innovative programs already underway, these parties should work out basic, visible reforms in trade, investment, and public-sector enterprises.

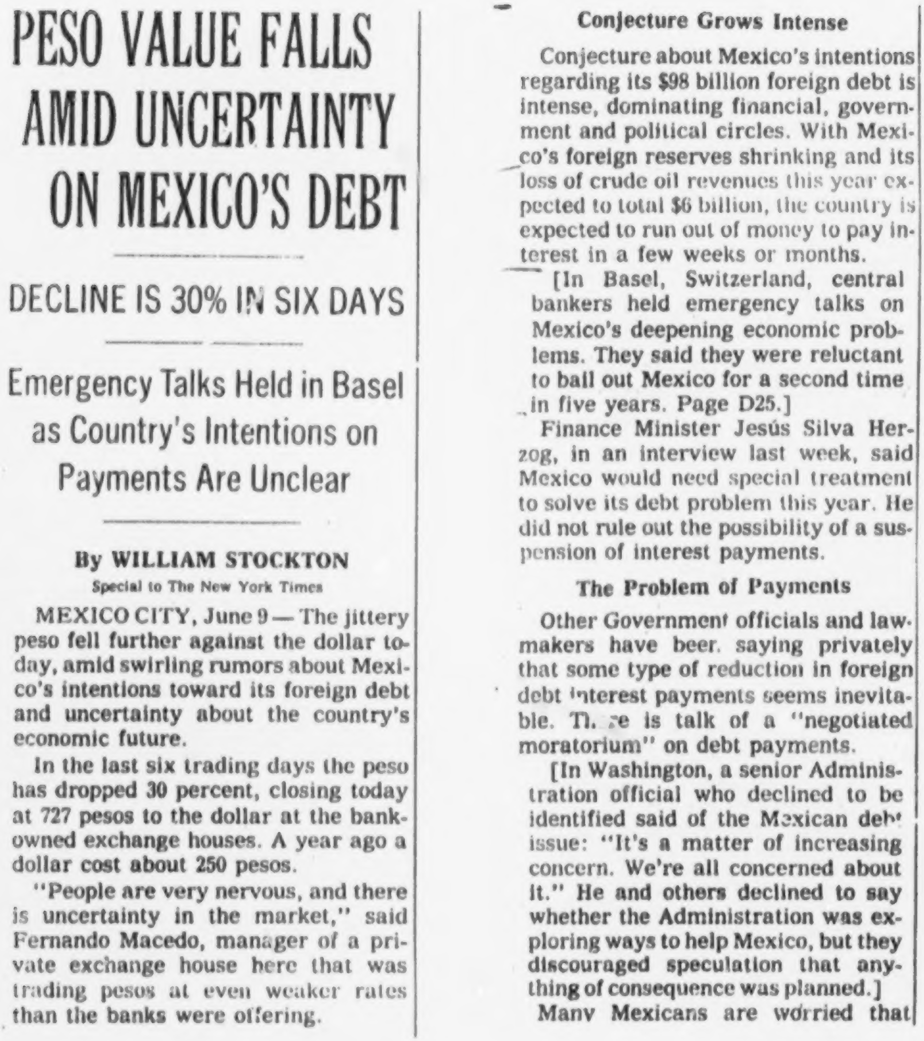
Mexico also needs a new deal from its creditors. Mexico cannot afford to continue to transfer such a large percentage of its foreign exchange earnings and domestic savings abroad if it is to resume investment and create jobs. Increased official flows are part of the answer, but the gap must be narrowed between the interest bill being paid to commercial banks and the amount of new money that they are willing to extend. To support Mexico's reform program, the U.S. government and the international lending agencies should lead the commercial banks into doing their part. Mexico can also work with its creditors to swap debt for equity, to convert debt into local currency, and to facilitate the sale of Mexican debt on secondary markets. Some of these arrangements might include contingency clauses that take into account shifting oil prices and interest rates.

There are further elements that could be added to these mutually-reinforcing new deals. To promote Mexican industry and its private sector, and to respond to Mexican trade liberalization, the United States and other OECD nations could agree to make reciprocal concessions in the upcoming negotiations under the General Agreements on Tariffs and Trade (GATT). The OECD countries might also purchase Mexican oil on long-term contracts and for their strategic stockpiles.

The entire program will require a strong endorsement by the entire United States government, in order to restore confidence in the Mexican currency and economy. Such a package deal could renew confidence in U.S.-Mexican relations, and transform a deepening distrust into a renewed partnership. It could also be a major triumph for American foreign policy.

RICHARD E. FEINBERG is Vice President at the Overseas Development Council (ODC). He served as the Latin American specialist on the Policy Planning Staff of the Department of State from 1977 to 1979. He holds a Ph.D. in economics from Stanford University, has worked as an international economist in the Treasury Department and with the House Banking Committee, and is an adjunct professor of international finance at the Georgetown University School of Foreign Service. Dr. Feinberg has held fellowships from the Brookings Institution, the Council on Foreign Relations, and the Woodrow Wilson International Center for Scholars, Smithsonian Institution. He has written numerous articles and books on U.S. foreign policy, Latin American politics, and international economics, including The Intemperate Zone: The Third World Challenge to U.S. Foreign Policy (W.W. Norton); (as editor) Central America: International Dimensions of the Crisis (Holmes and Meier); and Subsidizing Success: The Export-Import Bank in the U.S. Economy (Cambridge University Press.) He is also co-editor of ODC's U.S.-Third World Policy Perspectives series, whose current volumes include Adjustment Crisis in the Third World; Uncertain Future: Commercial Banks in the Third World; and Between Two Worlds: The World Bank in the Coming Decade.

(From The New York Times, Tuesday, June 10, 1986)



PESO VALUE FALLS AMID UNCERTAINTY ON MEXICO'S DEBT

DECLINE IS 30% IN SIX DAYS

Emergency Talks Held in Basel as Country's Intentions on Payments Are Unclear

By WILLIAM STOCKTON

Special to The New York Times

MEXICO CITY, June 9 — The jittery peso fell further against the dollar today, amid swirling rumors about Mexico's intentions toward its foreign debt and uncertainty about the country's economic future.

In the last six trading days the peso has dropped 30 percent, closing today at 727 pesos to the dollar at the bank-owned exchange houses. A year ago a dollar cost about 250 pesos.

"People are very nervous, and there is uncertainty in the market," said Fernando Macedo, manager of a private exchange house here that was trading pesos at even weaker rates than the banks were offering.

Conjecture Grows Intense

Conjecture about Mexico's intentions regarding its $98 billion foreign debt is intense, dominating financial, government and political circles. With Mexico's foreign reserves shrinking and its loss of crude oil revenues this year expected to total $6 billion, the country is expected to run out of money to pay interest in a few weeks or months.

[In Basel, Switzerland, central bankers held emergency talks on Mexico's deepening economic problems. They said they were reluctant to bail out Mexico for a second time in five years. Page D25.]

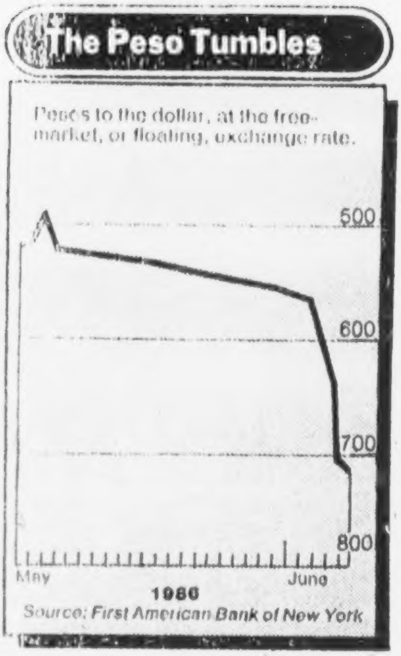
Finance Minister Jesús Silva Herzog, in an interview last week, said Mexico would need special treatment to solve its debt problem this year. He did not rule out the possibility of a suspension of interest payments.

The Problem of Payments

Other Government officials and lawmakers have been saying privately that some type of reduction in foreign debt interest payments seems inevitable. There is talk of a "negotiated moratorium" on debt payments.

[In Washington, a senior Administration official who declined to be identified said of the Mexican debt issue: "It's a matter of increasing concern. We're all concerned about it." He and others declined to say whether the Administration was exploring ways to help Mexico, but they discouraged speculation that anything of consequence was planned.]

Many Mexicans are worried that



The Peso Tumbles

Pesos to the dollar, at the free-market, or floating, exchange rate.

Source: *First American Bank of New York*

The New York Times / June 10, 1986

Peso Falls In Nervous Trading

Continued From Page 1

some Government action on the debt might aggravate relations with the United States, leading to further deterioration of the Mexican economy.

Adding to the economic pressure on Mexico was the announcement last Friday by the Bank of Mexico, the nation's central bank, that inflation during May was 5.6 percent. This brought inflation for the first five months of the year to 32.1 percent and raised the possibility that inflation by the end of 1986 might be 80 percent. Last year inflation in Mexico was 58 percent.

The plunge in the peso's value has come in the free exchange rate, which accounts for only 20 percent of the transactions in Mexico's currency.

The other 80 percent of peso transactions are carried out at a rate called the regulated float. It applies to import and export transactions, including sales of Mexico's crude oil, its largest source of foreign earnings.

The regulated float, which is set by Mexico's central bank and officials of nationalized commercial banks, has been sedately declining by 1.5 or 2 pesos a day against the dollar for several months. The regulated float today stood at 545.70 to buy a dollar, a difference of 33 percent from the free, bank-owned exchange rate.

Long lines stretching into the streets could be seen at exchange houses today as Mexicans sought to convert their pesos.

Banco International said it was limiting dollar purchases to transactions of $100. Banco Cremi said it had no dollars to sell today.

The Bank of Mexico has insisted for months that it does not intervene in the free peso market. But many bankers, economists and other analysts here have argued that it does.

They say the peso's fall probably has been caused partly by the central bank's decision not to use reserves to steady the free rate and the need to commit the reserves to more urgent uses in the country's economy.

Another cause of the peso's fall, according to economists here, is public concern over the economic situation and a desire to trade uncertain pesos for more secure dollars.

Meanwhile, Mexico continues its negotiations for a new agreement with the International Monetary Fund. Foreign bankers have said they will not open talks with Mexico about an additional $2.5 billion in fresh loans until an agreement has been reached with the I.M.F.

Negotiations have been under way for many weeks. The specific economic performance targets to which the I.M.F. wants Mexico to adhere are believed to be the sticking point.

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The I.M.F. wants Mexico to rein in its inflation and its federal budget deficit, which is running about 12 percent of the gross domestic product.

Bankers Stress Accord

By ERIC N. BERG

Bankers in New York said yesterday that it was crucial that Mexico quickly reach a lending agreement with the I.M.F. to keep from falling behind on its interest payments. A team of top Mexican officials is expected to travel to Washington this week to try to reach such an accord.

Bankers, speaking on condition that their names not be used, said they would not provide any more new money until the financial controls that an I.M.F. lending program would require had gone into effect.

They said that, in particular, Mexico's internal budget deficit remained too high and that the country would have to privatize companies that have been Government-run.

Mexico's leading bank creditors are Citibank, the Manufacturers Hanover Trust Company and the Bank of America.

Bankers said they were optimistic that an I.M.F. agreement could be reached quickly, thus averting a depletion of Mexico's dollar reserves and a financial crisis as in 1982.

Mexico's economy, they noted, although battered by the decline in oil prices, is in no worse shape than it was three months ago.

But some economists said the Mexican Government might soon devalue the currency to encourage exports and discourage imports. The decline of the peso may reflect speculators' anticipation of such a devaluation.

Others attributed the peso's fall to a belief by investors that the Mexicans would take no further action to control Government spending.

Bank Aid Unlikely for Mexico

By PAUL LEWIS

Special to The New York Times

BASEL, Switzerland, June 9 — Central banks are reluctant to bail out Mexico a second time in five years, and they apparently see that country's latest crisis as an opportunity to force the Government to put its economic house in order.

This attitude emerged clearly after central bank governors attending the annual meeting of the Bank for International Settlements held emergency talks today on Mexico's difficulties and on the danger that Mexico might soon suspend interest payments on some $98 billion of foreign debt.

These informal discussions took place on the sidelines of the meeting, and the bankers said that Mexico's deepening economic woes had become the issue of the moment because of fears the country might suspend its interest payments.

"We central bankers feel the problem is mainly in the hands of governments and international organizations like the International Monetary Fund and the World Bank," Jean Godeaux, governor of the Belgian central bank and president of the B.I.S., told a news conference after the meeting.

[In Washington, neither the Federal Reserve nor the Treasury would comment on the indication by the central bankers that a second Mexican bailout is not likely.]

Central Banks Concerned

Central bank governors from the industrialized Western nations, many developing countries and several Eastern bloc states were all gathered here for the meeting of the settlements bank. The B.I.S. acts as a clearinghouse for transactions between the central banks, and its published views represent those of the major central banks in the West that control it.

The governors also generally expressed hostility to calls for another concerted round of interest rate cuts to reduce the cost of credit and spur investments.

"Another round of cuts is unlikely and would be undesirable," said Alexandre Lamfalussy, managing director of the B.I.S. Central bankers expressed concern that a new rate cut by the United States might undermine the dollar and cause a rush of funds into West Germany. But they saw room for isolated cuts by some individual countries, such as France and Britain.

Central bankers insist that Mexico's current crisis is quite different from the financial difficulties of 1982. At that time, central bank governors, worried that Mexico would default on its loans and thus spark an international banking crisis, rapidly put together a $1.85 billion loan package.

Supply of Dollars

The Mexico peso has fallen about 25 percent against the dollar in the last week, amid fears Mexico may soon run out of dollars for servicing its debt as a result of the oil price collapse. The governor of the Mexican central bank, Miguel Mancera, chose not to attend today's B.I.S. meeting, in what was seen as another sign that Mexico's finances are in a critical state.

Mexico is engaged in drawn-out negotiations with the International Monetary Fund for aid, but there is no sign of agreement on the domestic economic reforms the fund wants in return for its help.

Mr. Lamfalussy told a news conference that Mexico's difficulties differed from the 1982 crisis in three main ways. He said that Mexico's creditor banks were now stronger; that the Mexican Government was better able to make tough decisions, and that Mexico's difficulties had not come as a complete surprise to the financial community.

Under these circumstances, central bankers generally want Mexico to reach speedy agreement with the I.M.F. on medium-term reforms that would strengthen its economy and lay the basis for renewed lending by commercial banks along the lines of proposals made last September by the United States Treasury Secretary, James A. Baker 3d.

Proposal for Debtor Nations

Mr. Baker urged debtor nations to adopt programs that would make their economies more efficient and export oriented. In return, these nations would get supplementary aid to tide them over until their foreign earnings improve. "Mexico has often been seen as a first candidate for the Baker plan and that has not changed," Mr. Godeaux said.

Bankers particularly fear that as its dollar reserves run down, Mexico may start making debt interest payments only in pesos. This would force creditor banks to make difficult decisions about valuing Mexican loans on their balance sheets.

"The markets think Mexico may convert its dollar debt into pesos and are trying to set a value for the peso in such circumstances," one banker said, referring to the Mexican currency's sharp decline last week. The reluctance of the central banks to bail out Mexico this time also reflect their concern that the Baker approach to the debt crisis is not being adopted.

In its annual report published today, the B.I.S. points out that none of the deeply indebted developing countries have yet agreed to make the kind of growth-oriented domestic reforms called for by Mr. Baker.

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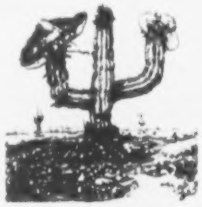

Awkward neighbours

Mexico is, as Ronald Reagan might put it, only a 15-minute drive from Harlingen, Texas. The intimacy of Mexico's relations with the United States has been a matter that concerned only those two in the past. But Mexico is now a country in trouble, and its trouble will affect the world.

In a week when the spot-market price of oil dipped below $10 a barrel, most people will think that Mexico's plight is financial. That, of course, is part of it. Although cheaper oil brings great benefits to the world as a whole, it will bring grief to a few: the businesses that serve the oil industry, the banks that have overlent to them and the countries that export oil. Of those countries, Mexico is the most precarious. Before the fall in oil, Mexico was already having trouble servicing its $97 billion foreign debt; and last year 70% of its export earnings came from oil. In the present talks with its creditors, Mexico deserves several billion dollars in new loans to help it adjust to an oil-price decline far steeper than anybody thought possible six months ago.

But Mexico faces much graver difficulties than the loss of a few billion dollars. Its political and economic life is clogged in ways that threaten to make it a disturbed place in the next few years (see pages 19-22). If it is disturbed, it will be disturbing—both to the United States and to America's European and Asian friends, who will not be getting the American attention they are used to if Mexico becomes the main foreign-policy preoccupation of the United States.

It might. Not for the reasons that have caused another Latin American trouble-spot, also measured in driving time from the Texas border, to monopolise the headlines. Nicaragua is a small country of 3m impoverished people whose only importance is that its Marxist-Leninist leaders have managed to enmesh it in the great gears of conflict between America and Russia. Mexico, a grand country of 80m people, is the world's second-most-indebted developing country, its tenth biggest economy, the cultural leader of the 260m Spanish-speaking Latin Americans.

It is not threatened, or not yet, by armed revolution. Its financial distress, though severe, will not be allowed to end in collapse—for the simple reason that the United States and its banking system could not tolerate it. But Mexico has, in common with most of Latin America, cultivated exactly the wrong habit of making politics the route to personal success and wealth, and is starting to pay the price in poverty and stagnation. Like Ferdinand Marcos's Philippines, Mexico has time to repent before serious social disorder overtakes it. The United States can give it a gentle shove in the right direction. Nobody, however, should underestimate how paralysed by intimacy the United States is likely to be as it makes policy towards its southern neighbour.

The foreigners within

Americans have always tended to see the rest of the world as a pale projection of their domestic drama. The principles Americans live by, and the passions of the immigrants' children who make up American society, matter in the making of American foreign policy much more than most non-Americans, brought up on the idea of national interest, are likely to believe. America's unflinching support for Israel is an example of how voters, pressure groups and popular beliefs can shape America's behaviour outside its borders.

Mexico's society penetrates the United States more deeply than Israel's, or any other, ever will. A third of the continental United States—and now its richest and fastest-growing part—was Mexican territory until just 140 years ago. There are 17m Americans of Hispanic descent—and more than 10m of them are Mexican in origin. On top of that, between 5m and 10m Mexicans live in the United States illegally. America's immigration service claims that nearly 2m Mexicans will be caught trying to enter the United States illegally this year. Nobody guesses how many will get through.

America's semi-permeable borders—which admit, legally and illegally, large numbers of the ambitious, the strong, the monied in almost exact proportion to their ambition, strength and wealth—are probably the country's greatest asset. But they make it even more difficult for the United States to treat the rest of the world as something other than an extension of itself. The 1,900-mile-long border with Mexico has for years frustrated America's immigration laws. But today's difficulties are nothing compared with those that would ensue if Mexico really went bad. Millions of Mexican families divided across an (improbably) enforced and hostile south-western American border would tie Washington decision-making in knots.

It need not go that far. The United States is facing in

Mexico, more intensely, the same failures that plague much of Latin America. American policy towards Mexico—and towards the rest of Latin America—ought to aim at helping it become more like East Asia: so that the Mexicans who now emigrate to Los Angeles and successfully set up book-binding factories or lawn-tending companies will decide that Guadalajara or Mexico City is the place to do so instead.

The United States has to be subtle about promoting such a change. Mexico is deeply sensitive to any hint of interference from the giant to its north, and is determined to be treated with respect as a power in the hemisphere. But it would not be amiss for the United States, entangled as it is in Mexico's destiny, quietly to promote two related notions in its neighbour.

The first is that an alternation of power between parties strengthens a country rather than weakens it. The second is that a free economy—with low barriers to trade, a warm welcome to foreign investment and decentralised decision-making—generates growth, while an economy in the hands of politicians generates only corruption. The collapse in the price of oil, so painful in the short run for Mexico's finances, offers Mexico the chance to turn its back on the policies that have been ruining it. Its neighbour to the north can help Mexico grab that chance.

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